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Accountant are the opinions of the writers of the articles and are not
necessarily endorsed by the Association.)*

Editorial Comment

Law of Negligence

We are indebted to *The Accountant*, the official publication of the Institute of Chartered Accountants in England and Wales, for permission to publish in THE CANADIAN CHARTERED ACCOUNTANT its current series of valuable articles under the heading "Accountants and the Law of Negligence." The first of these appears in this month's issue.

Canada, with Great Britain and other parts of the Empire, is passing through a period of emergency. It is highly desirable, then, for members of our profession, as the authors point out, to review the law of negligence generally and its application to the special conditions of such a period.

Revenue Expenditure

Not for some time have accountants had the opportunity of reading a court judgment which enunciates in so clear a manner the difference between a capital and a revenue expenditure as that delivered on 3rd January last by Mr. Justice Maclean of the Exchequer Court of Canada in the Dominion Natural Gas Company case. For that reason the editorial committee is publishing this month the full

text of the judgment. From the practising accountant's point of view, the courts have not always with clarity set out the reasons for their conclusions as to whether a particular outlay was a capital or a revenue charge. This judgment then is all the more welcome.

The distinction between capital and revenue expenditures has been stated by a number of authors of accounting textbooks. Hatfield, a leading authority on the subject in the United States, points out in his *Accounting* that the most commonly accepted criterion for the division of such expenditures is that "in so far as the transaction results in an addition of substantial and permanent character which increases the value of the plant, such increase should be shown as an asset." Cropper, whose *Accounting* is a standard reference in Great Britain, has stated: "Broadly speaking, it may be said that expenditure which extends or enhances the earning capacity of the original equipment, and enables it to earn more income, or to work at smaller cost, is capital expenditure. All other expenditure must be charged against the revenue earned by the equipment."

While the New Zealand case of *Ward and Company* referred to in this judgment has, as Mr. Justice Maclean stated, no bearing on the facts in the Dominion Natural Gas Company case, members of the profession will, on the particulars given, have doubts as to the soundness of the conclusions reached by the courts in that case. Apart altogether from the question of prohibition of intoxicants and the moral issues raised in that case, what difference, it may be asked, is there between this outlay by the *Ward Company* and the expenditure of any company on a program of advertising to promote its sales?

In his judgment Mr. Justice Maclean referred to a decision of Lord Romer, in which the following observation is, we think, of significance from the standpoint of the administration of the income tax: ". . . the question whether an expenditure made once and for all is or is not to be treated as chargeable to capital and not revenue is one of fact only. Being a question that the commissioners are eminently qualified to answer, it is to be hoped that in future they will answer it by reference to the language of the test laid down by Lord Cave, and not as though they are deciding a question of law."

Income Tax Administration "I want to emphasize again the essential part which this Institute can and should play in improving the administrative and substantive provisions of the tax laws.

You can contribute a vast fund of intimate practical experience with the operation of the law. You have a strong professional interest in its proper functioning. You have nearly as good a strategic position as the Treasury for directing the attention of the Congress to needed reform. I am personally very grateful for the co-operative spirit of the officers of the Institute and the members of its federal taxation committee during the past year. It is in the spirit of stimulating further co-operation that I have ventured to bring before you today some of the major items of unfinished business." These were the concluding words of an address which we had the privilege of hearing delivered at the annual meeting of the American Institute of Accountants at Cincinnati in September 1938 by Roswell Magill, the then under-secretary of the Treasury of the United States, who in a masterly way dealt with the subject of federal income tax administration in that country. Committees of the Institute had already given the government the benefit of their experience when new tax legislation was being considered; this was an invitation to the profession to lend its further advice and assistance towards the efficient operation of a department of government that reached into every part of the nation and came into direct contact with millions of its population. This appeal of the under-secretary is referred to here to emphasize the fact that the profession in the Dominion also has a distinct contribution to make towards the more progressive administration of income tax legislation in this country.

Legislative Considerations In any study of this matter there are, we think, two considerations of importance—the practicability of taxing provisions, and the decentralization of administration. Whether it can be set down to a measure of common sense or to the gift of foresight, the fact is that the British legislator has approached the responsibility of enacting tax legislation and other statutes in a manner which must win the admiration of Canadian legislators. In the debates of the British House of Commons there is

unmistakable evidence of an unwillingness on the part of the members to pass legislation until they have satisfied themselves that the administrative problems involved have been fully considered. For illustration we need only think back to the passage in 1929 of the Companies Act which, according to a recent statement in the British House of Commons, was under consideration and investigation for a period of no less than five years before it was finally approved by parliament.

When Germany went back on her pledges and war came last September, the Dominion government had to pass a number of emergency measures and consequently had not the time or the opportunity to make a close preliminary study of their provisions. The result was that there have been doubts in the minds of business men as to the exact significance of some of the provisions, for instance, of the *Excess Profits Tax Act*.

Referring again to the procedure followed in Great Britain, it is on record that the British excess profits tax legislation in 1915 was delayed a very considerable time so that its administrative features could be carefully studied; and when introducing the measure in Parliament the chancellor of the exchequer stressed the fact that although increased taxes must be levied it was equally important that the burdens being laid upon those responsible for administering the Act be not greater than that body could bear.

An Exemplary Provision

There is a feature of the tax legislation of last September, however, of very considerable merit. The provision that the increase in rates in the *Income War Tax Act*, in so far as corporations are concerned, shall not come into effect until a future date in 1940 is a step in the right direction, and the business man sees therein some promise of the discontinuance of the government's policy of passing retroactive tax legislation. He also has hope that another long overdue change in this Act is at hand when the Canadian legislator, catching the spirit behind British and United States tax legislation, will also provide that assessments in this country when once closed shall not be re-opened except in cases where fraud is proved.

*Creation of
Appeal Bodies*

Then there is the matter of decentralization or the providing of machinery throughout the country by which the taxpayer's liability can be determined promptly, inexpensively and finally. It was to be expected that following the passing of the *Income War Tax Act* time would be needed to build an organization for administering the Act. Great credit is due the federal tax department for what has been accomplished. As years pass, however, and district heads throughout the Dominion become familiar with the practical application of the Act, one would think that the necessity for referring questions involving accounting problems to the department at Ottawa would become less frequent and that only the isolated or extreme case would come before that department for decision. In other words, with the need for greater efficiency and despatch of business, a gradual decentralization should develop. The administration has to its credit the selection of officials of high rank and efficiency throughout the Dominion and at Ottawa during these years. Because of their knowledge, training, sense of responsibility and rectitude, the local inspectors and the expert advisers on their staffs are competent to deal finally with most of the returns in their respective divisions. If appeals from the local inspectors are necessary on questions of accounting facts, these should be provided at nominal cost through regional boards. These boards located conveniently throughout Canada should afford an opportunity for a local independent administrative review, and should consist of three individuals—a member of the bar with an expert knowledge of income tax law, a business man and a member of the accountancy profession. Appeals from the decisions of these boards could then be made to the Minister of National Revenue.

The taxpayers of Canada realize that increasing levies must be collected by the government in the critical days ahead. They are prepared to pay without murmur the full amount for which they are responsible under the Act. What they ask for and are entitled to receive, however, is greater promptness in having their assessments determined by the income tax division and a sympathetic hearing locally of all the facts in disputed cases. When these conditions are fulfilled there will develop between the taxpayer and the administration a confidence and a mutual respect

that will contribute, more than the income tax division has ever dared to hope, to the effective administration of the Act.

*History of
the Profession*

"That which history can give us best is the enthusiasm which it raises in our hearts." So wrote Goethe a century and a half ago, and time has if anything only served to enhance an enthusiasm and an interest in the subject. We publish this month the fascinating story of the three score years of professional progress in the province of Ontario. This account is welcomed not only for its record of events and developments but also because it will serve as an incentive to the different Institutes to complete a history of the profession in the other provinces.

History has been described as the depository of great actions. In any period there are personages whose contributions to the events of that period stand out above others. Those who have been members of the Ontario Institute for some time will, when reading this account, recall the names of a score or more who contributed in a marked way to the progress and well-being of the profession in their province. Among those playing such a role in this drama almost from the beginning is one still active in the profession; we have the pleasure to refer to George Edwards, C.B.E., F.C.A., LL.D., father of the writer of this history. Dr. Edwards became a member of the Ontario Institute in 1889 and, along with leaders in other parts of Canada after the turn of the century, had a vision of a Dominion-wide organization. When other provinces became ready to form institutes of chartered accountants, Dr. Edwards came forward and gave them the benefit of his experience in organization. It is natural then to find his name on the roll of the former presidents of the Dominion Association who have helped to establish the profession on a sound foundation in Canada. That roll of professional leaders is published at page 4 of the 1939-40 year book of our Association.

This reference to personages gives us the happy opportunity of mentioning a unique function which took place in Montreal on 15th January last. On that day two distinguished brothers and leaders in the profession in the Province of Quebec—A. F. C. Ross, F.C.A., and John W.

EDITORIALS

Ross, F.C.A., LL.D.—celebrated their seventieth birthday at a luncheon arranged by the firm of which they are members. Another brother in the profession, Major-General James G. Ross, C.M.G., F.C.A., who was also present at the function, is the oldest living member of the Society of Chartered Accountants of the Province of Quebec, and Mr. A. F. C. Ross and Dr. John W. Ross are the second and third respectively on the list for that honour.

THREE SCORE YEARS

Historical Highlights in the Growth and Development of the Institute of Chartered Accountants of Ontario

By H. Percy Edwards, F.C.A., Toronto

IN reviewing the events of history as they relate to the Institute of Chartered Accountants of Ontario, one is impressed with the difficulty of presenting a readable story of the growth and development of the profession in Ontario.

Two methods are used by writers in the presentation of historical happenings. The one builds a story of individual heroism around certain facts, which are purely incidental, producing in the reader an immediate interest without lingering impressions. The other method deals with facts and enlists the co-operation of the reader in the building up of scenic effects. In this recital of incidents, the latter method will be followed. There are dates and figures to satisfy the average statistician and heroes aplenty for those who care to enter into the spirit of the times when the following events took place.

While the Institute did not receive its charter until the year 1883, the work of organization dates back to a meeting held on 11th November 1879 at the office of Robins, Myles & Co. "in response to invitations issued in the names of Messrs. William Anderson, James B. Boustead, Wm. Badenach, Thos. Bailey, E. R. C. Clarkson, A. B. Campbell, Wm. Fahey, R. H. Gray, W. F. Munroe, A. W. Murdock, Benjamin Morton and Wm. Robins, dated 6th November 1879 and sent to all the public accountants, accountants in banks, monetary institutions and insurance companies, representative bookkeepers and others in Toronto."

Eighteen persons were in attendance and upon hearing explained the purpose in calling the meeting it was resolved "That it is desirable to form an Association of Accountants for the Dominion of Canada." At this meeting Wm. Robins, Wm. Fahey, M. Robins, H. W. Eddis and Wm. Anderson were elected to be the original members of the Institute and to ballot for applicants and prepare a constitution and by-laws, and it was resolved "That it be an instruction to the original members now elected to frame the rules, as far as possible on the model of the Institute of Accountants of Great Britain, and also to provide that the original mem-

bers shall themselves be submitted to any examination imposed upon members who may hereafter be elected."

Several meetings of the original members were held at which thirty-two applicants were balloted upon and elected to membership. A constitution and by-laws were prepared and consideration given to the matter of incorporation.

The first general meeting was held on 10th December 1879, with an attendance of twenty-four original and elected members. The original members, in conformity with the understanding at the time of their election, retired and submitted their applications for membership. Upon a ballot being taken they were elected to membership. The constitution and by-laws of the "Institute of Accountants and Adjusters of Canada" were adopted.

The meeting proceeded to elect the Council by balloting for the nine Fellows who shall, with the President and Vice-President, constitute the same. The result of the ballot was the election of Messrs. Wm. Anderson, Hugh Scott, Wm. Badenach, E. R. C. Clarkson, James E. Day, Wm. Robins, Charles Robertson, James Watson and D. O'Reilly. The meeting was adjourned and upon being reconvened on 23rd December, Charles Robertson was elected President and Wm. Anderson Vice-President of the Institute. The meeting was adjourned to 30th December at which time the members balloted to elect two members to Council to fill vacancies resulting from the election of the President and Vice-President. On the first ballot F. J. Minet was elected but the second, third and fourth ballots failed to elect a second member. The meeting was then adjourned to 6th January 1880 at which time H. W. Eddis was elected to Council on the first ballot.

Between adjournments of the general meeting, Council met and appointed Wm. Robins to be Secretary-Treasurer and instructed him to procure the necessary books and stationery. James E. Day undertook to see the President of the Board of Trade as to getting the use of their rooms. The Secretary reported to Council on 22nd January that \$80.00 in fees had been received and an account opened with the Imperial Bank; also that he had purchased a table for \$20.00 which was approved.

That the accountants of those times experienced a pressure of work during the early months of the year seems

to be borne out by the fact that general meetings called for 30th January and 19th February failed for lack of a quorum and the Council meeting of 10th March suffered a similar fate.

At its meeting on 15th March 1880, Council ordered that the offer of the Board of Trade for the use of a room at \$80.00 per annum, without taxes, be accepted. Little time was lost in completing the arrangements and moving the table, and such other furnishings as may have been acquired, into the new offices, for the records indicate that a general meeting of the members was held on 15th April in the rooms of the Institute at the Board of Trade.

Meanwhile Council considered the question of examination subjects and diplomas and the extension of its field of influence. Committees were appointed to confer with accountants in Hamilton and London. Success attended this effort to the extent that eight persons from London and one each from Brantford and Belleville submitted applications and were received into membership. Among these persons was J. W. Johnston of Belleville who later served on Council and as President of the Institute. From Hamilton were received eight applications including those of J. J. Mason and W. F. Findlay who are numbered among the earlier elected Presidents who so ably directed the Institute's affairs.

In May 1880 a Committee was appointed to purchase a book case and lamps for the room. Up to this time there is no indication that books had been purchased or donated for the purposes of equipping a library, but doubtless some unrecorded acquisitions had taken place, as the first recorded purchase was in January of the following year when "It was recorded that Dun, Wiman & Co.'s book on Mercantile Law be purchased for the use of the Institute."

On 31st December 1880, the Institute closed its accounts and presented its first annual report which showed a total membership of fifty-nine, of whom forty-three were residents of Toronto, eight of Hamilton, six of London and one each of Belleville and Brantford. Total receipts as shown by the audited financial statement amounted to \$526.00, derived from entrance fees and annual subscriptions at the rate of \$10.00 each from Toronto members and \$6.00 each from members outside of Toronto. The sums

so collected from each member were apportioned equally between entrance fees and annual subscriptions.

Disbursements during the year included, in addition to the usual items of rent, printing and stationery, postage, etc., the cost of table and cartage \$21.00; bookcase \$28.00; ballot box, lamps, etc. \$12.00, allowance to the Secretary of \$40.00, and a balance of cash on deposit amounting to \$68.33 was carried forward to the new year.

Under the Presidency of Wm. Anderson the work of organization and education continued. "The Secretary was empowered to open a correspondence with the Institutes of Accountants of Great Britain, having in view an affiliation with them for the mutual benefit of members of each Institution on both sides of the Atlantic." This effort was not successful and in his report to Council on 23rd September 1881, the President stated that upon the occasion of his late visit to England he had been informed "The Charter of the English Company however prevented such affiliation," a condition which still exists.

A series of addresses was given by members of the Institute upon subjects of interest to the membership and to the business public. The first of these was given by the President on 22nd March 1881 at Shaftsbury Hall upon the subject "The value and scope of accountants' work." Press reports the following day in *The Globe*, *The Telegram* and *The Mail* indicated a well attended meeting and an instructive address.

Other papers were read during the year. On 21st April E. R. C. Clarkson addressed a meeting upon the subject of "Insolvency" and one month later H. W. Eddis spoke on the subject "Balance sheets." In September, October and November, three papers were given, the first by W. A. Douglas "The Accounts of building and loan societies," the second by J. T. Moore on "Life insurance contracts" and the last on the subject of "Joint stock company's bookkeeping" by J. W. Johnson of Belleville.

Application for Incorporation—An unsuccessful attempt was made to secure incorporation by Special Act of the Legislature. In his address to the annual meeting the President reported that the government had not acceded to the request, but stated, "We earnestly recommend our successors in office to renew the application next session, with, we trust, a more favourable result."

During that year the membership was increased by fifteen new members in Toronto and thirty from other places including Kingston and Cobourg not previously represented. Revenues from entrance fees and annual subscriptions reached a total of \$464.00, an excess over expenditure of \$59.81, for the year, so that with the balance brought forward from the previous year of \$68.33 the Institute closed its accounts with a favourable bank balance of \$128.14 "which it was expected would be increased by some subscriptions which may still be collected."

By special permission of His Worship the Mayor and the City Council, President S. B. Harman presented his inaugural address in the Council Chamber at the City Hall on 18th May 1882. Before a large attendance of prominent citizens and members Mr. Harman reviewed the progress of growth and development of the Institute and similar societies in other parts of the world, particularly in Great Britain.

The aims and objects of the Institute were dealt with at great length and reference made to the fact that schools and colleges "to foster and encourage science and art, have been founded to give the stamp of efficiency to those they send forth as their recognized alumni; but the profession of an Accountant seems to have been hardly yet recognized as one deserving like evidence, or that free-masonry of association which has done so much to elevate other callings."

Another quotation from his address is particularly interesting in the light of the present day organization of our profession throughout Canada. He said "and another point I take pleasure in suggesting hopefully, if not prophetically, namely, that the Institute of Ontario may so advance in public favour, that the other Provinces may follow the movement, and the day be not far distant, when, by a happy union, Canada at large may become the field of labour and usefulness of a Dominion Institute."

In closing Mr. Harman impressed upon his audience that "the arduous profession of an accountant is one which, rightly undertaken, elevates the labour employed, and raises the treatment of figures to the nature of a science, thus justifying the motto adopted for the seal of the Institute of Accountants of Ontario 'Scientia et Labore.'"

The reader may have noticed that the name of the Institute has been varied from that originally decided upon. From time to time the minutes of meeting indicate that the constitution had been subjected to amendment but, unfortunately, in no case has the specific amendment been recorded.

Events of importance marked the year of 1882. The City of Toronto invited the Institute to be represented upon a committee charged with arranging for the semi-centennial celebration, to be held in 1884 of the incorporation of Toronto in 1834. An invitation was extended by the Institute of Accountants and Bookkeepers of New York to be represented at its first annual meeting to be held on 15th March 1883.

Addresses by W. A. Douglas upon the subject "Financial fallacies" in October and by R. H. Tomlinson on "Commercial crises" in November of that year would seem to indicate that business and financial conditions were suffering from some sort of disturbance. Nevertheless the Institute renewed its application to the legislature for a Special Act of Incorporation.

In presenting its petition for incorporation great care was taken to acquaint the members of the legislature with all phases of the Institute's objects and activities. When presented the petition was accompanied by a list of 211 names of accountants from 22 cities and towns in Ontario and elsewhere.

On 9th March 1883, the President addressed the Institute and at some length reviewed the events respecting the Charter "which," he said, "it was a matter of satisfaction had been successfully carried in the Legislature and was now the law of the land as 46 Victoria (1882-3) Chapter 62."

And so, cradled in a voluntary association, was born the "Institute of Chartered Accountants of Ontario."

No time was lost in amending the by-laws to conform to the Act of Incorporation, and those members not specifically named in the petition were asked to renew their application for membership. One hundred and sixteen immediately responded and were duly elected members.

The financial statement for the year showed revenues from all sources to be \$755.00 which included \$30.00 proceeds

from the sale of a table, presumably that piece of furniture purchased for \$20.00 as already noted. Expenditures totalled \$638.55 and an accumulated balance of cash on hand and on deposit of \$244.59, was carried forward to the succeeding year.

Due to the heavy demands upon the time of the President and Council in obtaining the charter of incorporation and the work of organization which immediately followed, a formal presentation of the accounts was not made, but instead two years' accounts were presented to the annual meeting held on 7th March 1884. The report of the President stated the position of the membership to be: charter members, 17; members re-elected, 115; new members elected after charter, 29; members awaiting re-election, 2; members awaiting election, 12—a total of 175 of whom 78 were resident in Toronto and 97 elsewhere. The balance of cash on hand and in bank was \$411.40, with \$264.00 annual dues in arrears but considered good.

At this meeting were recorded resolutions of condolence to the families of Charles Robertson and William Anderson, whose deaths were recorded as of the first and second Presidents of the Institute.

Mr. Harman retired from the Presidency and was succeeded by J. J. Mason, Mayor of the City of Hamilton. In passing, it is worthy of note that Mr. Harman served the City of Toronto as its Chief Magistrate during the years 1869 and 1870.

In his inaugural address, delivered to the meeting of the Institute, President Mason referred to the Institute's incorporation and particularly to the services rendered by the retiring President in this regard. He dwelt at some length upon the lack of educational facilities in the schools and colleges as they related to the subjects of bookkeeping and political economy, and the position the Institute must take to promote the skill and competency of its members as a duty imposed by its charter.

Reference was made to "the advance of progress in the Dominion of Canada in its development of manufacture and commerce and the extension of banking and railway enterprises and their demand for extreme care and precaution in the method of keeping accounts."

Qualifying Examinations—In the period which followed,

Council completed the framing of rules for the examination of candidates for the Diploma of Fellowship and the Certificate of Competency. The requirements of examination for the diploma called for "such high qualifications and recognized efficiency, as shall warrant the Council in endorsing the candidate for the practice of a public accountant."

The certificate required of the candidate a familiarity with the principles which govern all accounts and the exhibition of good methods in his own department. He was not expected to exhibit a knowledge of "modes of recording and distributing which prevail in lines of business foreign to his own experience." A wider range of knowledge than that required was taken into account and a certificate was graded according to the marks obtained in excess of the number required to pass. Holders of the certificate were privileged to enter for higher grade for one-half the original fee.

In his report to the annual meeting held on 17th April 1885, the President referred to the rules regarding examinations and the granting of diplomas and certificates to its members. He "earnestly hoped that as the important question of Diplomas and Certificates has now been decided, the prosecution of the work of the Institute will be vigorously conducted and that the members generally during the coming year will avail themselves of the opportunity of obtaining Diplomas and Certificates as authorized by the Act of Incorporation."

The quotation just given appears to deserve more than passing mention. There is, in the minds of many, an impression that the early members secured the privilege of designating themselves chartered accountants without passing through the examination experience. The writer has always understood that examination has been the only gateway to the qualifying as a chartered accountant. This appears to be borne out by the records, for we find the name of E. R. C. Clarkson among the petitioners for the Charter of Incorporation and later as having presented himself for examination for the diploma entitling him to use the designation "Chartered Accountant."

Further confirmation is given to this position in the absence of any mass effort toward the granting or obtaining

this title. In fact at each holding of examinations, the number of persons presenting themselves for examination is small and then, as now, there were those who failed to satisfy the requirements placed upon intending candidates.

The affairs of the Institute progressed in an orderly manner without incident calling for special mention here. That all members had not availed themselves of the invitation to sit for examination is evidenced by a minute of Council in October 1887, whereby the Secretary was instructed to notify those not in full membership to desist in using the term "Chartered Accountant."

The following month Council published a declaration that the designation "Chartered Public Accountant" shall belong exclusively to Fellows of the Institute practising as public accountants while continuing in membership.

The first recorded granting of the diploma to members of other accounting societies was upon the application of Michael Crawley, who, upon production of his certificate of Fellowship in the Society of Accountants and Auditors of London, England, was awarded the diploma of this Institute.

From this time until 1894 there is no item of particular interest to record. Meetings of Council and committees were frequent. By-laws were from time to time amended and improved to meet the needs of the Institute. Examination procedure was improved upon and the publication of examination papers, previously used, produced some revenue by their sale to intending candidates who in those days were handicapped by the absence of texts and other means of preparation for examination.

Admission of Women—In 1894 Council met to consider the case of a lady who was an unsuccessful candidate for the diploma at the recent examinations. A general discussion took place and it was decided if an offer of an Associate Certificate would be acceptable to her, it would be issued as provided by the by-laws. The lady in question notified Council that the offer of the Associate Certificate was acceptable to her, and so was postponed for a short time the problem of admitting women to practise in the profession.

The postponement was brief, for in the following year three more applications of like nature were received and

considered by Council. In the discussion which followed many and varied were the reasons given by the individual members for admitting or barring of women as members. Some expressed the opinion that the nature of the accountant's duties in factory and arbitration work was unsuitable for ladies; some considered that "the employment of women clerks was detrimental to the value of male labour;" one feared that in the case of all other conditions, as to skill and academic standing, being equal, employment would be given to women because of the lower fee which would be asked. Others expressed themselves as considering that proficiency shown in passing the examinations should be the test as to their admissibility. Upon a vote being taken it was unanimously decided against the admission of women to membership and in reaching this decision Council was in a large measure guided by the precedent of other intellectual societies. Upon this decision the Council of 1912 refused the applications of two ladies desiring to sit for examination.

While upon this subject it may be permissible to bridge the gap of years and deal finally with this question. With each application discussions followed and eventually ladies were permitted to qualify and sit for examination. The changed attitude of other professions and the general entry of women into the business life of the time were the determining factors. In February of 1930 among those admitted to membership was Mrs. Helen Burpee (*née* Sutcliffe), the first lady to qualify and become a chartered accountant in Ontario.

Lest an impression may have been given to the reader that the period from 1887 to 1894 was without activity, it should be stated here that the Presidents and Councils of those years vigorously pursued a policy of improving the organization and standing of the Institute in its sphere of influence.

Early Educational Efforts—Regular meetings were held and papers read by leading members upon subjects of particular interest to members and students. Text books were recommended to students to assist them in preparing for examinations. Arrangements were made with Upper Canada College, which school had established a department devoted to the study of accounts, and also with the Northern

Business College, Owen Sound, and the Ontario Business College, Belleville, to become affiliated with the Institute.

The masters of these affiliated schools being members of the Institute, it was arranged that they should conduct the primary examinations of the Institute, under rules to be prepared by the Examination Committee. Other business colleges became affiliated from time to time, to enjoy the same privilege.

Students' Association—This manner of conducting the primary examinations through the facilities of affiliated schools was established under rules framed by the examination committee in 1893. The committee drew up forms for the use of applicants for examination and membership. There were five of these forms of which one is to be noted, viz., "Student-Associate." The adoption of this registration and application was the beginning of the Students' Association which was to become an important factor in the education and preparation of students for membership in the Institute.

Reference has been made to the membership which in 1884 stood at a total of 175 members all told. During the ten years following, the numerical strength of the Institute was greatly reduced. Many of the earlier members did not avail themselves of the invitations to qualify for the designation of chartered accountant, mainly for the reason that they were not engaged in public practice and therefore saw no advantage in doing so. Many names were struck from the roll because of non-payment of their annual dues. The roll in 1894 showed a total registration of 78 members. This roll further shows that total charges to members for annual subscriptions, entrance and examination fees in that year amounted to \$623.00, not including arrears from the previous year amounting to the sum of \$183.50, and as collections for that year amounted to only \$506.00, the amount of \$300.50 in arrears was carried forward to the following year.

While sustaining loss in numbers the Institute gained in quality of men who took the affairs of their profession very seriously. Up to this time there had been three complaints lodged with Council having to do with the conduct of members in their professional practice. This is evidence of the desire then, as now, to keep the standard of practice

on such a plane as would demand the confidence of the business public in its members.

A subject which received more than passing attention was that of municipal accounting and in this regard representations were made to the government of the day for legislation which would improve the conditions then existing.

It will be remembered there was a favourable cash balance amounting to \$128.14 at the close of the year 1881, but despite the reduced membership revenue, and the expenditures made to promote and further its objects, the financial statement for the year 1894 showed a balance of funds on deposit of \$360.44 to the credit of the Institute.

Dominion-wide Organization—We move forward again over a period of progress to the year 1902 when on 15th February a special general meeting was called to discuss a public notice to the effect that an application would be made to Parliament to incorporate an Institute of Accountancy which would provide that its members would be permitted to style themselves "Chartered Accountants."

The opinion of this meeting was that the application constituted a grave menace to the Institute and that the co-operation of like bodies should be sought to oppose the application. Assurances of co-operation were received from the societies in Montreal and Winnipeg and a decision was reached that opposition should be in the form of an application to parliament for a bill which would include the desirable features, but at the same time safeguard the interests of existing bodies.

Efforts were made to reach an agreement with the promoters of the bill whereby objectionable clauses granting educational powers would be removed and the corporate name and titles changed so as not to conflict with those made commercially valuable by this Institute. In the result the original bill was amended and Section 3 provided,—

"The Association shall be composed of all members in good standing of existing provincial incorporated institutes and associations, who shall apply for membership within one year after the passing of this Act, and of any other persons of whose qualifications and fitness the Council approves."

On 15th May 1902, the Act to Incorporate the Dominion

Association of Chartered Accountants received assent. In his report to the annual meeting of the Institute in July 1902 the President, Wilton C. Eddis, referred to this Act and stated "what influence it will have on us chartered accountants, or this Institute, it is premature and would be unwise to form an opinion." He indicated that the members of the Institute would have the position of charter members of the Association and probably would shortly be invited to attend its first meeting.

Nothing more was heard about this matter until about November when the Institute took appropriate steps to qualify its members to become members of the Dominion Association under the terms of section three of the Dominion Act. It was then learned that the plan of organization of the Dominion Association was such as to include the majority of the Ontario Institute members on terms less favourable than had been anticipated.

For six years the Dominion Association carried on as an independent organization of professional accountants while the Ontario Institute continued to function as formerly. With two bodies, each qualifying chartered accountants in accordance with its own standards, the public mind was becoming confused in the acceptance of the degree.

In an effort to clear up this situation the Institute, in 1908, sought from the Ontario Legislature powers to regulate and control the practice of the profession in that Province. An act was passed, which by its terms reserved the right to use the designation "Chartered Accountant" to the members of the Ontario Institute.

Upon the passing of this Act legal representatives of the Institute in England and Wales conferred with those of the Ontario Institute and an agreement was reached so as to avoid any possible difficulties which might arise. The Dominion Association, however, asked and obtained an Order of Disallowance.

Then followed an extensive campaign of articles in one of the leading financial journals which were intended to inform the business public upon the facts relating to the organization of the profession in Ontario and elsewhere in Canada. The effect and result was to bring the Dominion Association and the various Provincial Societies together, and a settlement of all problems was reached when the

Dominion Association passed under the control of all the Provincial Societies of whom it was henceforth to be composed. Re-enactment of the disallowed legislation was asked and obtained. Matters of organization were completed which established the profession in Canada upon a basis the equal of any other country.

The difficult experiences through which the Institute had passed were not reflected in its statistical record. In 1908 the report of President J. W. Johnston, delivered to the annual meeting held that year in Belleville, stated that the membership at that time consisted of 105 associates and 22 fellows. During that year 87 applications were received for permission to write the Primary examination, for the Intermediate 111, and for the Final 33 applications.

Financial conditions had improved. During that year \$306.77 of net revenue was carried to surplus account, and the accumulated surplus amounted to \$1,715.36, of which over \$1,000 was on deposit and over \$300 invested in furniture account.

The Students' Association, as may be gathered from the number of applicants for examination, was an active body and conducted series of lectures to aid its members in preparation for the examination ordeal. In the early days the examinations were indeed difficult. By comparison with those of today they may not so appear but on the other side of the ledger is to be noted that there were no prescribed study courses to guide the student or indicate the matter upon which the examiner might delight to test his skill and competency. In a later chapter we shall follow the efforts of the Institute to equip its students and members for the tasks which lay ahead.

The library had grown to a total of 117 units including text books, journals and financial reports although carried conservatively at \$9.43 in the balance sheet.

We have reached at this point the twenty-fifth anniversary of incorporation. Those who met in Belleville in that year included some who had been active throughout the development of the Institute, and to them the pride of achievement during the quarter century became an incentive to lead the way to greater progress.

The hope of the first President, S. B. Harman, that other provinces might follow the movement of Ontario was being

realized. A society in Montreal had already been incorporated in 1880, Manitoba followed with an incorporation in 1886, Nova Scotia was next in 1900. Following the incorporation of the Dominion Association, the profession in British Columbia obtained its charter in 1905. In 1908, the year of the Dominion-Provincial differences, Saskatchewan granted incorporation, to be followed in 1910 by Alberta; New Brunswick was a "war baby" born in 1916, and in 1921 the Prince Edward Island Institute was incorporated, thus completing the organization of chartered accountants throughout Canada.

By 1913 the affairs of the Institute had grown to such proportions that it became necessary to appoint a full time Registrar to fulfil the requirements of that office. To that position was appointed W. J. Valleau who rendered faithful and valuable service over a long period of years. Upon his retirement in 1935 he was unanimously elected an Honorary Life member of the Institute.

In 1911 the first issue of THE CANADIAN CHARTERED ACCOUNTANT was published by The Dominion Association of Chartered Accountants. Shortly after his appointment as Registrar of the Ontario Institute, Mr. Valleau assumed the duties of Editor of the magazine until succeeded by Austin H. Carr in 1930 upon his appointment as Secretary-Treasurer of the Dominion Association. The development of the Magazine under the direction of Mr. Carr is a matter of Dominion Association history and has no place in this narrative. It is a matter of satisfaction to the Institute that through the temporary use of its facilities it has accelerated the more recent development of the Dominion Association affairs.

Profession and the Great War—The profession in Ontario, as elsewhere, looks back upon the years of the Great War with a sense of pride that the Institute and its members played their part with distinction in that drama. The annual report upon the affairs of the year ending 30th June 1918 showed that the Institute had expended the sum of one thousand dollars in the purchase of a Lewis machine gun and seven hundred dollars had been subscribed to the British and Canadian Red Cross Societies. This contribution amounted to thirty-seven per centum of the Institute's surplus, accumulated over a period of thirty-eight years.

The total enrolment of members and students stood at two hundred and fifty-two, of whom sixty had enlisted for overseas service prior to the introduction of compulsory service. To this number, approximately twenty-five per centum, there were many others who also served in like manner and in other capacities for which their training and skill admirably fitted them.

The financial burdens imposed by the war produced a system of taxation which immediately broadened the scope of the accountants' work and established a higher requisite standard of skill and knowledge in the profession.

Accordingly educational facilities were geared up to keep pace with the greater demands upon the professional accountant. The library facilities had been improved and the number of volumes stood at 445, a sizable increase over the number previously reported.

Courses of Instruction—With the stepping up of examination standards the greater was the necessity of providing a study programme for the student body. A board of instruction, consisting of George Edwards, Chairman; T. Watson Sime, Rutherford Williamson and R. Easton Burns, was appointed to negotiate with existing schools for such a course of instruction. Arrangements were completed with Queen's University to conduct the courses on behalf of the Institute.

The Board of Instruction was appointed on 10th January 1921, and under its direction a Select Committee of members of the Institute in collaboration with the Faculty of the University produced a course of lessons which were put into operation on 1st January of the following year. These courses called first, second and third year were designed respectively for primary, intermediate and final examinations and it was made compulsory that students complete the respective courses before sitting for examination.

The effort was a creditable one both from the standpoint of speed in preparation and thoroughness of the material supplied. Its reception by the students indicated that it was filling a long felt need.

The Institute might have capitalized upon these courses by making them available to any who wished to subscribe, but decided to restrict their use to its registered students.

The courses were, however, made available to the students of other provincial bodies with whom Ontario had affiliation through the Dominion Association.

The study courses have been constantly under revision and have been expanded so as now to provide instruction over a five-year period. So well has this course been received that one might say it is "standard equipment" for students of six out of the nine Provincial Institutes. The widespread use of the Ontario study course has done much to bring about a uniformity of standards among the various Institutes; in the year 1939 the nine Provincial Institutes agreed upon a standardized examination for their candidates qualifying for membership.

In 1933 another milestone was passed when in a manner befitting the occasion the Institute celebrated its Golden Anniversary. The celebration took the form of a dinner at which over four hundred members and students were in attendance. Guests honouring the gathering included the Premier of the Province, the Mayor of Toronto, representatives of the Law Society and other professional bodies together with representatives from the Dominion Association, the Provincial Societies and the American Institute of Accountants. This occasion being of recent date is well within the recollection of the majority of our members, and was well reported in *THE CANADIAN CHARTERED ACCOUNTANT* in the March issue of that year.

A mark of the success achieved during the half-century is the membership of 591 persons, many of whom have taken residence in countries throughout the world. At this writing the Institute boasts of a total membership of 844 with 437 registered students progressing towards their degree of Chartered Accountant.

Financially the Institute has now reached the position that it has accumulated a surplus sufficient for any contingency which might arise. Accordingly it has revised downward, the annual fees of its members so that revenues about equal expenditures and services are rendered at cost. This position has been attained since 1924, for it was in that year that the surplus of \$8,553.01 was almost wiped out by the failure of the Home Bank. The loss provided for out of surplus amounted to \$8,318.07 upon which no recoveries have been realized. It was the irony of fate that this de-

INCOME WAR TAX ACT DECISION

pository was the only one of the chartered banks which did not engage a chartered accountant to audit its accounts.

In its recovery the Institute has not profited financially from its study courses. Any surplus from their operation is used in revising and keeping up to date the subject matter of the lesson material.

The position of the Institute of Chartered Accountants today is the result of much time and thought given unstintingly by members too numerous to have allowed of individual mention here. Upon the walls of the Council Chamber arranged in the order of their tenure in office are the portraits of all the Institute's Past Presidents keeping watch over the deliberations of their successors in the direction of the Institute's affairs.

Toronto, 28th December 1939.

INCOME WAR TAX ACT DECISION

Judgment re Legal Expenses Incurred by Company in Defending its Franchise Rights

Following is the full text of the judgment of Mr. Justice Maclean:

The Dominion Natural Gas Company Limited, *Appellant*
and

The Minister of National Revenue, *Respondent*
(The Exchequer Court of Canada — Maclean, J.,
3rd January 1940)

This is an appeal from the decision of the Minister of National Revenue and relates to a claim for deduction on an assessment for income tax, for the fiscal year ended December 31, 1934.

The facts may be briefly stated. The appellant, hereinafter called "the Dominion Company," was possessed of a franchise to supply gas to the inhabitants of the City of Hamilton and elsewhere, and the United Gas and Fuel Company of Hamilton, Ltd., hereinafter called "the United Company," also had a franchise to supply gas to the inhabitants of the City of Hamilton. In 1931, the United Company brought an action against the Dominion Company

claiming (1) a declaration that the Dominion Company was wrongfully maintaining its mains in the streets of the City of Hamilton and wrongfully supplying gas to the inhabitants of that city, (2) an injunction restraining the Dominion Company from continuing so to use the streets of the city and from continuing to supply gas to the inhabitants, (3) a mandatory order requiring the Dominion Company to remove its mains and other property from the streets and elsewhere in the city, and (4) damages. The Dominion Company, as might be expected, considered this as a very serious attack upon its franchise rights and privileges, and its trade, and its directing officers were of the view that it was obliged to contest the action.

In due course the action came on for trial before the Supreme Court of Ontario, and the action was dismissed. An appeal was then taken by the United Company from the decision of the trial Court to the Appellate Division of the Supreme Court of Ontario and the appeal was dismissed. The United Company then appealed to the Judicial Committee of the Privy Council, and again it was unsuccessful. All this litigation cost the Dominion Company \$48,560.94, in addition to any taxed costs recovered against the United Company.

There came a time when the Dominion Company was required to file its income tax return for the year 1934, which it did, showing its taxable income to be \$202,326.86, but this was later increased by the taxing authorities to \$250,890.80, and this resulted from the disallowance as an item of trade expense the said sum of \$48,560.94, the legal expenses incurred by the Dominion Company in resisting the action of the United Company. And the question for decision is whether the said sum is allowable as a deduction in computing the taxable income of the Dominion Company for the taxation period in question.

The Dominion Company contends that the said sum disbursed for legal expenses was a necessary one in the conduct of its trade, and that it is an allowable deduction under the provisions of the *Income War Tax Act*. On behalf of the Minister it was conceded that the said legal expenses were incurred by the Dominion Company in defending the said action, and that the said sum was so expended, but, it is contended, that the same was not an expense wholly, exclusively and necessarily laid out or ex-

pended by the Dominion Company for the purpose of earning its income, and was in fact an expense incurred with a view to preventing the extinction or partial extinction of a profit earning enterprise; and that the sum expended as legal fees by the Dominion Company was an application of earned profits for the purpose of earning future profits, and therefore an expenditure on account of capital, one not permissible as a deduction in computing the Dominion Company's assessable income under the Act.

The sections of the *Income War Tax Act* which are at all relevant here may at once be referred to. First, s. 3 defines "income" to mean the "annual net profit or gain or gratuity . . . or as being profits from a trade or commercial or financial or other business or calling. . . ." Then, s. 5 provides that "income," as defined by the Act, shall be subject to certain exemptions and deductions, and they are therein enumerated. Then, s. 6, the important section in this case, enumerates a number of cases in which deductions are not to be allowed in computing the amount of the profits or gains to be assessed. Sec. 6 in part reads thus:

6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
 - (a) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;
 - (b) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided in this Act.

As I shall have occasion later to mention, the deductions that are permitted to a trader in computing his profits or gains are not affirmatively stated in the Act. They are to be ascertained by an examination of the deductions which are not allowed.

As a number of English decisions were cited before me it may be desirable to refer briefly to the provisions of the English Income Tax Acts which correspond to s. 6(a) and (b) of the *Income War Tax Act*. The English Acts prohibit deductions in respect of "any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purpose of the trade, profession, employment or vocation." This provision corresponds closely to s. 6(a) of the Canadian Act. The Acts provide that any capital withdrawn from, or any sum employed or intended

to be employed as capital in the trade, is not deductible, and also any capital employed in improvements of premises occupied for the purposes of the trade. It is of course fundamental that any profit made from the sale or realization of a capital asset is not a receipt of the trade. In England, capital is treated as being either fixed or circulating. A fixed capital asset is described as an asset which it is intended to keep and use in a trade, and a circulating asset as an asset which is acquired or manufactured for the purpose of being turned over or sold in the course of carrying on trade. Outgoings which result in the acquisition of a fixed capital asset, or which produce an advantage of a permanent and enduring nature are not deductible, but such advantage must be analogous to an asset. For example, the following items have been held by the English Courts not to be deductible: The expenses of removal to new premises or the fitting up of new shops; the cost of conversion of premises; the cost of dredging a deep-water channel; the cost of improvement of the permanent way of a railway; the payment for surface damage by a colliery; the cost of a surrender of leases; the cost of draining a mine in preparation for new operations; the payment to an insurance company for a policy to underwrite the liability of a trader to pay pensions; a sum paid for an option to purchase fixed capital assets; the expenses of an issue of debentures; and the loss on shares acquired for business purposes. Several of these examples were cited before me by counsel for the Minister as illustrative of the capital nature of the legal expenses in question here.

As I propose referring later to some American cases it will be as appropriate here as elsewhere to refer to two or three provisions of the statute there in force in respect of the income tax. The Revenue Laws of the United States provide that in computing net income there shall be allowed as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . ." That provision is the one corresponding to s. 6(a) of the Canadian Act. In computing net income no deduction is permissible in respect of "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate," or in respect of "any amount expended in restoring property or in making good the ex-

haustion thereof for which an allowance is or has been made;" so far as I can observe those are the principal provisions referable to capital disbursements.

The *Income War Tax Act*, as has been said of the corresponding English Act, does not provide a code of the law on the subject of income. It is silent as to many matters of the first importance. For example, the Act contains no explicit directions that in computing the profits of a trade any expense (as to which there is no express prohibition) is to be deducted, if on the facts of the case it is a proper debit item to be charged against incomings. The generally recognized rule as regards trade expenses is that a deduction is permissible which is justifiable on business and accountancy principles, but this principle is subject to certain specific statutory provisions, which prohibit the allowance of certain expenses as deductions in computing the net profit or gain to be assessed. To the extent that ordinary business and accountancy principles are not invaded by the statute they prevail. In computing the amount of the profits and gains to be assessed the Act does not sanction specific deductions, but by prohibiting certain deductions it impliedly allows other deductions. In order that a trade expense may be allowable as a deduction, the amount expended must be, "wholly, exclusively and necessarily" laid out for the purpose of "earning the income," which means the "annual net profit or gain," but this must not be construed so as to preclude the deduction of those expenses as a result of which receipts of profits may accrue in the future. The principle is well established that expenses to earn future profits are allowable deductions, for example, the cost of a reasonable amount of advertising is usually admitted as a business expense, although the result of a particular advertisement might not be reflected in the year in which the cost was incurred. Nor does it follow that all the deductions a trader might make in ascertaining his profit are necessarily allowed by the Act as an expense or deduction. Therefore, in considering what is an allowable expense or deduction, we must first enquire whether it is one prohibited by the Act; if it is not prohibited, then we must consider next whether it is of such a nature that according to sound business and accountancy principles it is a proper item to be charged against the receipts in a computation of the annual net profit or gain, and was ex-

pending for earning the same, and therefore allowable, or, whether it is an expense that should be charged as a capital expenditure, and therefore one not deductible in computing the amount of the profit or gain to be assessed. In the case under consideration, the legal expenses incurred by the Dominion Company do not fall within the prohibited deductions and the question to be determined is whether it was one that should be charged against revenue or against capital. If it was properly a charge against revenue then the appeal herein must be allowed, if against capital then the appeal must be refused.

A number of English authorities were cited before me on behalf of the respondent in support of the contention that the expenditure here was a non-recurring expense, an expenditure made once and for all, and therefore a charge against capital and not deductible in ascertaining the net profit or gain for the purpose of the income tax. That contention was the subject of discussion in the case of *Anglo-Persian Oil Co. v. Dale*.¹ In that case there will be found, in the judgment of Lord Hanworth, M.R., a reference to several cases of the nature cited before me, and possibly others. The question there was whether a sum paid by the Anglo-Persian Oil Company to terminate an agency was an admissible deduction. The Commissioners held it was not an admissible deduction in computing the profits and gains of the company. On appeal, Rowlatt, J. held it was a revenue payment and was deductible in ascertaining the net profits of the company, and in this he was sustained by the Court of Appeal. I would refer particularly to a passage from the judgment of Romer, L.J., wherein, after a reference to some of the difficulties encountered in determining what are permissible deductions, he proceeded to say:

At the end of the year 1925, however, all these authorities were considered by the House of Lords in *British Insulated and Helsby Cables v. Atherton*, and the law applicable to such cases as the present was, as it seems to me, placed beyond the realms of controversy. The boundary line between deductions that were permissible and those that were not had previously been uncertain and difficult to follow. As regards the large majority of deductions, there was and could be no conceivable doubt. They were clearly on one side of the line or the other. But as regards a comparatively small number, it was difficult to say on which side of the line they fell. This was particularly the case where, as in the present one, an expenditure is not a recurring

¹1932, 1 K.B.D. 124.

one, but is made once and for all. It was pointed out by Lord Cave in *Atherton's* case that an expenditure, although made once and for all, may nevertheless be treated as a revenue expenditure, and he then added this: "But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."

It should be remembered, in connection with this passage, that the expenditure is to be attributed to capital if it be made "with a view" to bringing an asset or advantage into existence. It is not necessary that it should have that result. It is also to be observed that the asset or advantage is to be for the "enduring" benefit of the trade. I agree with Rowlatt, J. that by "enduring" is meant "enduring in the way that fixed capital endures." An expenditure on acquiring floating capital is not made with a view to acquiring an enduring asset. It is made with a view to acquiring an asset that may be turned over in the course of trade at a comparatively early date. Nor, of course, need the advantage be of a positive character. The advantage may consist in the getting rid of an item of fixed capital that is of an onerous character, as was pointed out by this Court in *Mallett v. Staveley Coal & Iron Co.*

Now this being the test to be applied in such cases as the present, it is obvious that the question whether an expenditure made once and for all is or is not to be treated as chargeable to capital and not revenue is one of fact only. Being a question that the Commissioners are eminently qualified to answer, it is to be hoped that in future they will answer it by reference to the language of the test laid down by Lord Cave, and not as though they are deciding a question of law. Too often in the past the Commissioners have found that a particular sum is or is not a permissible deduction. That is a question of law, or at any rate mixed law and fact. If they will find that the expenditure in question was or was not made, as the case may be, with a view to bringing into existence some asset or advantage for the enduring benefit of the trade, their finding will be one of fact, and if there be some evidence upon which the finding can reasonably be made, it will not be subject to review in the Courts.

I am of the opinion that the expenditure in question here cannot be said to be a capital outlay or loss, that is to say, it was not, in the language of the Act, an "outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence." There would seem to be no warrant for holding that the fixed capital of the Dominion Company was benefited by the expenditure, or that its trade from a capital point of view gained any advantage by the expenditure. No advantage accrued to the capital of the Dominion Company by the success attending its defence of the action brought against it. The situation as to capital remained as it was.

We may then consider if the expenditure in question was one necessarily incurred for the purpose of earning

the income, within the meaning of s. 6(a) of the Act. As has been frequently said, no degree of ingenuity can frame a formula so precise and comprehensive as to solve all the questions that may arise in computing the annual net profit or gain of a trader, and reasoning by analogy from the facts of one case to the facts of another case is not entirely satisfactory and is liable to lead to erroneous conclusions. I understood Mr. Lynch-Staunton to say on the hearing of this appeal that the revenue authorities had actually allowed, tentatively at least, as a deduction, the legal expenses of both the Dominion Company and the United Company, but this decision or ruling was apparently not adhered to. I mentioned this only as an indication of the difficulties frequently encountered in deciding whether or not an expenditure incurred was one necessary for earning the annual net profit or gain.

Considerable reliance was placed by counsel for the respondent on the case of *Ward & Company Ltd. v. Commissioner of Taxes*², and therefore I feel compelled to make a brief reference to it. There the taxpayer, a brewery company, made certain expenditures with a view of influencing public opinion in a poll of the voters of New Zealand about to be held on the question of the prohibition of intoxicants, by printing and distributing anti-prohibition literature. The taxpayer sought to deduct the expenditure in the assessment of the income derived from its business on the ground that it was made for the purpose of preventing the extinction or depreciation of the business from which the income was derived. It was held by the New Zealand Court of Appeal that no deduction was allowable in respect of such an expenditure because it was "not exclusively incurred in the production of the assessable income . . .," which decision was, on appeal to the Judicial Committee of the Privy Council, sustained, their Lordships holding that the expenditure was a voluntary expense incurred with a view to influencing public opinion, and not one necessary for the production of profit, and that it was not in fact incurred for that purpose. I should not have thought myself that any other conclusion was possible, but at any rate it is not, in my opinion, an authority applicable to the state of facts here.

²1923, A.C. 145.

No distinction is to be drawn between legal expenses and other business expenses. The question always is whether the expense was a necessary one for the purpose of earning the annual net profit or gain of the taxpayer. In the well known case of *Usher's Wiltshire Brewery Ltd. v. Bruce*³, legal expenses were allowed as a deduction. In that case these expenses consisted of "solicitors' costs and disbursements in respect of the renewal of publicans' licenses, surrenders, terminations and assignments of leases or tenancy agreements, the assessments of tied houses, obtaining a full license, complaints against tenants, and advising as to thefts of beer." There is little discussion in the speeches of their Lordships concerning the particular deduction claimed for legal expenses, and, in fact, it would appear that no objection was taken by the Attorney-General against their allowance. The legal expenses were held to be a proper debit in ascertaining the balance of profit and loss in the taxpayer's trade. In Gordon's *Digest of Income Tax Cases*, under the caption of "Legal, Auditing and Technical Expenses," will be found reference to several cases in which legal expenses were allowed as deductions, and other cases in which they were disallowed.

I might now refer to some United States cases which involved the question of the allowance of legal expenses as deductions in computing the net taxable income of the taxpayer. As earlier mentioned, the United States statute provides that "in computing net income there shall be allowed as deductions all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In *Kornhauser v. United States*⁴, it was held by the Supreme Court of the United States that, where a taxpayer successfully defended an accounting suit brought by his former law partner respecting shares of stock which the taxpayer had received for professional services performed by him, during the existence of the partnership as the partner alleged, but after its termination as claimed by the taxpayer, the legal expenses paid by the taxpayer in defending the suit were deductible from gross income as "an ordinary and necessary business expense" incurred in carrying on a business. In *Commissioner v. Peoples-Pittsburgh Trust Co.*⁵, it was held that ex-

³1915, A.C. p. 433; ⁴276 U.S. 145; ⁵60 Fed. (2nd) 187.

penses incurred by the taxpayer in successfully defending himself against a criminal charge involving fraud in making up the income tax return of a corporation of which he was chairman were deductible in his personal income tax return as an "ordinary and necessary business expense." In *Commissioner v. Continental Screen Co.*⁶, attorneys were employed to represent the taxpayer before the Federal Trade Commission on a charge of operating in violation of the Sherman Anti-Trust Act, with the result that an order was eventually made dismissing the complaint. The legal fees paid to the Attorneys were held deductible in computing net income. The circuit Court of Appeals, Sixth District, in this case said: "The proceeding before the Trade Commission was undoubtedly an 'action' against the respondent which was 'directly connected with' or which 'proximately resulted' from its business. To respondent's board of directors the situation was ominous. The life of the business was endangered. Under such circumstances respondent followed the very natural and ordinary procedure suggested by the vital necessity of the situation. It employed counsel to protect its interest and agreed to pay for their services. Any other course upon the part of its board of directors would have been unusual and would, no doubt, have subjected them to well founded criticism by its stockholders." This case was cited with approval by the Circuit Court of Appeals, Second Circuit, in the case of *National Outdoor Advertising Bureau v. Helvering*⁷, on the ground that "the taxpayer's resistance was there justified and was necessary to the protection of his business." In *Citron Byer Co. v. Commissioner*⁸, a corporation and two of its officers were indicted for an alleged offense which arose directly out of its business, and it being determined by the court that no such offense had been committed it was held that the legal fees paid by the corporation to counsel, in defending the prosecution, were deductible and constituted an ordinary and necessary business expense.

It seems to me that if legal expenses are incurred in successfully defending an action in which one's title to existing assets, rights or facilities, are put in serious question, such expenses should normally be admissible as deductions, and particularly would this be so in the case

⁶58 Fed. (2nd) 625; ⁷89 Fed. (2nd) 878; ⁸21 B.T.A. 308.

where the earning of profits are directly dependent upon and require the utilization of such assets, rights or facilities, as was the case here. If the action is unsuccessfully defended the revenue authorities might contend that there was no asset, right or facility to defend, and that therefore such expenses should not be allowed as a deduction in computing net taxable income, but that is not this case. If such expenses arose out of the promotion or acquisition of additional assets, rights or facilities, it is probable no deduction would be permissible. It was imperative here that the Dominion Company defend the action and the failure of its directors to do so would probably have rendered themselves liable in damages to the shareholders of that company. The action threatened the earnings of the Dominion Company, wholly or partially, and had the action succeeded it would have been unable to sell gas, at least in some sections of the City of Hamilton; the company's capacity to earn revenue was put in jeopardy and, I think, it is immaterial that its capital assets, or some of them, were incidentally threatened with extinction or depreciation. It was because the Dominion Company was producing and selling gas that it had to defend the action and thus protect and preserve its credit and its revenue. The United Company sought an injunction restraining the Dominion Company from continuing to supply gas to the inhabitants of the City of Hamilton, which, had the United Company been successful, would have prevented the Dominion Company from earning its usual revenue. The advantages and benefits accruing from the successful defence of the action were of a revenue character, and the cost of the same was, I think, a necessary expense in carrying on the trade, and in earning the annual net profit and gain. It seems to me that the legal expenses here incurred cannot be regarded as anything else than a charge against revenue. In my opinion the legal expenses incurred by the Dominion Company were incident to its trade, and were incurred for the purposes of its trade and the earning of its annual net profit or gain. I therefore think that the deduction claimed by the Dominion Company should be allowed. The appeal is therefore allowed and with costs.

WAR-TIME FINANCE

Editor's Note: This is the fifth in a series of articles by Professor McQueen of the University of Manitoba on financing the war.

IN corroboration of his position that labour in spite of the wage rate increases of the last war did not improve its position in terms of goods and services Mr. Keynes presented some figures in an article in *The London Times* of November 28th. He there shows that while the cost of living index rose from 100 in 1914 to 180 in 1917 the index of wage rates rose only from 100 to 140. This meant that in terms of goods and services obtainable a given hour's labour yielded only about eighty per cent as much in 1917 as it did in 1914. Considering however that the number of hours worked by the average worker was increasing over the interval, what was lost because each hour worked yielded less goods and services was gained by the greater number of hours worked. The result was that the consumption of real goods and services by the working class remained approximately constant over the period with the significant difference however that members of this class were working much harder and longer for the same result in 1917 than they were in 1914. The inequity involved in this situation was masked at the time by the inflation which was going on. Mr. Keynes' proposal for "compulsory savings" outlined previously in these notes was devised to assist a baffled Chancellor of the Exchequer and to spread the costs of this war fairly on the generation which alone will fight it and pay for it. As was seen previously there is no way available to make posterity pay for the war.

The gross taxable income of the United Kingdom for 1939 is estimated at some £5,700 millions out of which consumption expenditure was some £4,350 millions, some two thirds of which was consumption expenditure by the wage earning and salary classes with incomes of less than £250 per annum. By taking up the slack in unemployment and by increasing the length of the working day somewhat Mr. Keynes assumes that the income of the United Kingdom will be increased by some fifteen per cent to twenty per cent. The most of this increase will go to that income-group earning less than £10 per week and consequently the greater part of it will be spent for consumers goods

unless steps are taken to prevent this happening, and we saw why Mr. Keynes thinks such steps should be taken.

The present increase in government expenditures due to the war is some £1500 millions per annum which will presumably increase though it cannot increase greatly without some more fundamental change in our institutions than we have yet contemplated. Of this increase Mr. Keynes estimates that one half can be found from the sale of foreign assets, depleting of stocks, postponed depreciation and borrowing while the other half can be obtained from the increased output of industry provided that the increased output is not accompanied by any increase in private consumption. How, it may well be asked, can we contemplate an increase in incomes of some fifteen per cent to twenty per cent without bringing about an increase in private consumption? The answer is that it is only possible if an amount equal to this increased income is handed back to the Treasury by way of taxes or savings, voluntary or involuntary. Even with existing taxes—and they are already very high on all incomes above the lowest—there would still be some £525 millions of new income which must be mopped up if it is not to go flowing through to the consumers goods markets raising the prices of goods there but calling no more of these goods into being. It is a stern war and resources must not be permitted to be used to increase consumers goods but they must be available only for war requirements.

As was seen above not much of this £525 millions will be voluntarily saved since it will go largely to income groups who will not save much of it. To get such a sum back to the Treasury, say, by a new wage-tax would mean a wage-tax of some three shillings in the £ which tax would not be in fact and could not be made to appear equitable. A sales tax of some twenty-five per cent might be adequate for the purpose but such taxes are well known to be acutely regressive. Inflation is a fraud both to the working class and to other classes and favours only the entrepreneurial group. In justice to all Mr. Keynes says there is only one thing to do and that is to bring about an additional compulsory saving of some £400 millions per annum.

These savings, as we saw, would be available as deferred purchasing power after the war to those from whom they

were abstracted during the struggle. They would be of such an amount that along with taxation and borrowing the demand for consumers goods during the war would be restricted to the minimum consistent with efficiency. There would be no inflation of prices with wages lagging behind and the result would be that the real wages of labour would be increased by eight per cent to ten per cent above what they otherwise would be. Mr. Keynes also shows that that group with fixed incomes of from £5 to £15 per week would fare better than under alternative methods of war finance.

Assuming an increase of £1,750 millions for war purposes total government expenditure will be brought to some £2,750 millions per annum. Estimating the gross taxable income of the United Kingdom at £5,700 millions there may be added to it some £750 millions when full employment is attained. £2,750 millions of government expenditures out of an income of £6,450 millions when expressed as a percentage is a sobering figure. With the prospect of a long war we obviously need all the help we can get from men of Mr. Keynes' proven capacity.

R. McQueen.

ACCOUNTANTS AND THE LAW OF NEGLIGENCE

By W. Summerfield and F. B. Reynolds
London, England

Editor's Note—This series of articles on a subject of wide interest to accountants, written by W. Summerfield, M.A., B.C.L., LL.B., and F. B. Reynolds, A.C.I.B.—authorities in the fields of law and insurance respectively—and appearing in *The Accountant* (London), is published with the kind permission of the Editor of that magazine.

EMERGENCY conditions render appreciation of the principles of the law of negligence (always of great importance to the practising accountant) absolutely vital, through a variety of causes.

(a) Experienced members of the accountant's staff being absent on war or other forms of national service, erroneous work on the part of the rest of the staff is more liable to occur and give rise to claims against the firm.

(b) In so far as new staff is recruited by the accountant, even if they are experienced workers, they are likely to be quite inexperienced in relation to the specialized accounts of their new employer's more important clients.

(c) The clients' own staffs, furthermore, will be depleted, or "diluted" by inexperienced newcomers; consequently, mistakes in the keeping of the books will be more likely to have occurred before the accountant begins his work upon them, and the accountant, therefore, will need to exercise even more stringent care than usual to avoid negligence.

(d) The absence of the client's regular staff affords additional opportunities for the accountant to discover any defalcations which may have been concealed; such opportunities are, in normal times, limited practically to holiday periods or absence during illness; failure to discover defalcations where facilities are greater than in normal times increases liability to claims for negligence.

(e) The difficulties of working with new assistants, upon books kept by new staffs, are intensified by the novel conditions under which business in general is conducted, especially in cases where evacuation has taken place, with the result that staffs and records are scattered and the accountant's labour of detection is made more difficult. In addition, effective "trap" questions can be deprived of much of their force by the counter-activities of the fraudulent-minded who can more easily conceal, or delay the discovery of records, when armed with the ready-to-hand excuse that missing documents may be elsewhere. Centralized accounts are an efficient check when in constant operation, but their efficiency is gravely impaired by enforced temporary decentralization.

(f) Further difficulties are introduced by novel legislation. Vital changes are rapidly made in laws affecting finance, e.g., income-tax, and in those affecting industry and commerce—which vest super-control and direction in state departments. The accountant must have regard not only to the instructions of his clients but also to the requirements of numerous government officials. How numerous and varied the latter may become is illustrated by the fact that during the first few weeks of the present war upwards of fifty Acts and more than a hundred sets of statutory orders were brought into operation, practically all of which must be reflected in the books of account of all forms of business enterprise. For their purposes old methods must be hastily adapted and new systems in-

stalled to meet the rapidly-changing conditions. Innovations inevitably introduce new seeds of negligence and negligence claims.

It is highly desirable, therefore, to review the law of negligence generally and its application to the special conditions of a period of emergency. It must be premised, however, that lack of competent staff will generally prove no defence to an accountant called upon to meet a charge of negligence: if he was unable to satisfy himself that he was competently equipped to undertake the clients' work he should not have embarked upon it. At the same time, all the circumstances must be taken into consideration by the Court in each case brought before it, and such circumstances, looked at as a whole, may lead to the conclusion that the accountant was not negligent since no reasonably competent accountant could have done the work more efficiently in the business conditions produced by the emergency. No general rule as to the effect of war conditions upon liability for negligence can be so stated as to be applicable to accountancy work in general. The rules of law remain constant, although new conditions may alter the facts to which such rules fall to be applied by the Courts.

Negligence

Negligence Defined Broadly—Negligence is definable as want of due care or attention. In law it may be regarded as the negation of diligence, and legal liability flows from the failure to discharge a legal duty to exercise diligence. Such a legal duty may arise in a variety of ways, e.g., (a) from the duties imposed upon all by the general law of the land—whether by the common law or by statute; or (b) it may flow from a special duty which is imposed upon special categories of persons or in special or specific circumstances, e.g., the duty imposed upon motorists to drive their vehicles with due care and attention, so as to have regard for the safety of other persons using the highways; again, special duties rest upon those who own property which may occasion damage or loss to other persons; or, (c) the duty to exercise diligence may flow from contract. It is the last-mentioned category of negligence with which we are here primarily concerned.

For, although the accountant may (like other persons) find himself from time to time faced with a claim for

damages in respect of his negligence arising from any one of the types of circumstance above referred to, in his professional capacity he is concerned solely with those classes of claims which may be brought against him by clients (or former clients) in respect of transactions conducted by him in such professional capacity. But cases occur, as we shall see, where it is not easy to determine whether the accountant, in relation to a particular transaction, was acting in his personal or his professional capacity. There are, also, cases in which third parties may bring claims against him in respect of transactions arising in the course of the discharge of his professional functions.

Claims Increasing—The importance of this aspect of the law of negligence has always been manifest, but in recent years it has tended to increase enormously. In the first place, the development of the practical application of the invention of the internal combustion engine has, as Lord Hewart (the learned Lord Chief Justice of England) recently observed, largely increased, year by year, the volume of litigation arising from alleged negligent driving. The general public has by reason thereof become increasingly law-of-negligence-minded, with the result that they have become more prone to consider the possibility of launching claims for negligence against their accountants, although, of course, quite different aspects of the law of negligence fall to be applied in the latter type of case.

Partnership Risks — Secondly, although originally accountancy was designed to be practised by individual accountants, the ever-increasing complexity of commercial life has resulted in accountants practising as firms; in such cases, owing to the general rules of law relating to partnership duties, responsibilities and liabilities, an accountant may be called upon to meet a claim, or to defend an action, in respect of transactions conducted entirely by his partner. An additional risk arises when a practitioner, during the temporary absence on holiday or through illness of his partner, handles the affairs of a client of the latter. For, normally, each partner devotes himself to his own clients; the work of the office being thus departmentalized a partner is on less sure ground when helping out with the comparatively unfamiliar work of his colleague.

Large Firms—Thirdly (and as a corollary to the second consideration above mentioned), firms of accountants tend

to increase in size, so that they become under the necessity of employing increasingly large staffs; and for the conduct of their employees such firms are just as much liable as are other employers. Indeed, their responsibilities in this connection are greater than those of the average employer, since the employee of an accountant, particularly if he is a qualified accountant, often discharges functions of a highly responsible character, viz., supervising the execution in detail of the programme of work planned and mapped out by the employer. It is the employer who is responsible in law for the due execution of the whole of the work, and liable, accordingly, for the negligence of the employee.

Diversified Practice—Fourthly, members of the public have come to regard the accountant not merely as a professional expert in relation to books of account but also in relation to all manner of financial and business transactions. The accountant has become, in fact, the client's general "man-of-affairs" (to employ a term more familiar abroad than with us). Nor has the accountant disdained the description of "doctor of commerce" so frequently applied to him by appreciative clients and by public men. In order to deal with the almost infinite varieties of commercial transactions on which he may be called upon to advise, or in respect of which he may be retained to act on behalf of clients, the accountant would require to be familiar with more specialized subjects than is possible for "one small head" to carry. It is not surprising, therefore, to observe that the accountant must frequently invoke the co-operation, or the specialized aid, of other professional men and experts, e.g., solicitors and counsel, insurance brokers, stockbrokers, estate agents, valuers, assessors and so on. Arising from the labours of such experts the accountant may be called upon to answer for negligence, either solely, or jointly with the expert more directly responsible.

Insurance Cover—The legal risks involved in the practice of accountancy are thus of a comprehensive character. In stressing these it is not our purpose to raise horrifying spectres, but rather to emphasize the moral that in professional practice (as in other aspects of life) the best method of fore-arming is to heed fore-warnings. Side by side, indeed, with the extension of the accountant's responsibility has grown the system of insurance designed to relieve, so far as may be, the heavy burden of responsibility

which might otherwise fall upon the unsupported shoulders of the accountant.

Forms of policies of insurance exist giving more or less comprehensive cover against the risks which he runs under the law of negligence, but these contain limitations, inherent in policies or flowing from the restrictions imposed by the general law of the land. Even, therefore, if protected by insurance the accountant is not entirely absolved from liability under the law of negligence. This aspect, often overlooked, is vitally important, and will be dealt with separately.

No General Definition—Negligence is the negation of duty. Just as it is impossible to give a general, comprehensive definition of duty, since duty must be defined in relation to time, place and circumstance, so, too, is it with negligence—*Thomas v. Quartermain* ([1887] 18 Q.B.D. 685); *Vaughan v. Taff Vale Railway Company* ([1860] 5 H. & N. 679, 688).

Considerations of the time, place and other circumstances which must be assessed in relation to negligence alleged against an accountant are dependent upon the terms of his retainer by his client. The retainer may be (a) contained in a specific agreement made between the accountant and the client, defining the scope of the work undertaken by the former for the latter; or (b) it may be left to be implied, as to its details, from the relationship of the accountant to the client, i.e., it may be presumed to embody the terms and conditions usually contained in the terms of employment of an accountant. With regard to the latter (implied terms of contract), the Court will have regard to evidence tendered by recognized authorities in the profession; whilst with regard to the former (express terms of contract), the specific agreement between the parties will fall to be construed just as other kinds of contracts are construed.

Since the accountant discharges such varied functions as acting as accountant or auditor, or trustee, or liquidator or the like, it is essential in any disputed case to be able to arrive at a decision at the outset as to which one or more of his several possible functions the accountant undertook to discharge in the particular case. That function must, however, be still more closely analyzed, since each function

admits of a variety of sub-divisions, e.g., an accountant may undertake to do a full or a partial audit; he may undertake the audit of the head office of a multiple concern, without undertaking any responsibility in relation to the branches; he may undertake an examination of accounts for income-tax purposes only; or, again, he may undertake a special investigation for a specific purpose. In all these cases the accountant may be stigmatized as negligent only if he has been negligent in relation to the particular duty which he undertook; the amount of his remuneration may afford an indication, in cases of doubt, as to the extent of the duties which he, presumably, undertook; but that is an indication only, and far from a conclusive factor. (See, further, *post.*)

Loss Limited—The effective remedy for a client who has proved negligence against his accountant is monetary compensation, to reimburse him his losses resulting from that negligence. But losses in respect of which compensation is claimed must be shown to be the consequence of the accountant's negligence; to prove negligence without loss, is as inadequate as to prove loss without negligence.

Auditor's Duties Defined—As is to be expected, since auditing constitutes the bulk of the work of the average accountant, it is arising from auditing cases that the Courts have provided the most useful definitions. In relation to auditing, again, it is to be observed that the bulk of auditing work is in connection with the accounts of limited companies, since commercial, industrial and financial enterprises tend increasingly to be conducted in that form. To a lesser, but still to a very substantial degree, the accountant is called upon to audit partnership accounts. Then there is the vast range of individuals' accounts. In relation to each of these classes of accounts, varying aspects of duty are presented to the Courts for consideration, and consequently varying definitions are made available by judicial dicta. Those definitions vary, of course, not as to essential principles, but as to the varied circumstances in which the accountant must discharge his duties. Thus, in auditing the accounts of a limited company the accountant must bear constantly in mind the numerous statutory provisions applicable to the conduct of such audits; and the judicial definitions derived from company cases must be read in relation to those statutory requirements. For,

an accountant who conducts an audit which, upon general principles, appears to have been conducted with care and due diligence may, if the accounts happen to be those of a limited company, involve himself in a claim for negligence because, for example, he has failed to ensure communication of data to the shareholders where circumstances warrant such communication, even though he appears to have discharged his duties to the company itself or to its directors. *Pendleburys Ltd. v. Ellis Green & Co.* [1936] Accountant Law Reports, (see, further, *post*).

Re London and General Bank (No. 2) ([1895] 2 Ch. 673, C.A.) affords an admirable illustration of how the judiciary have regarded the scope of the duties of auditors. In that case, it was held that the auditor had been guilty of misfeasance — under the *Companies (Winding-Up) Act*, 1890, Section 10 — and, consequently, liable to make good the amount of the dividend paid which, it was shown, had been declared not out of income, but out of capital. The Court considered in detail the nature of the confidential report which the auditor had presented to the directors (drawing their attention to the inadequacy of the securities affecting the capital investments of the company and the difficulty of realizing them), and the factor that in reporting to the shareholders, he had confined himself to a much more guarded notification, (*viz.*, as to the value of the assets being dependent on realization).

In the course of his judgment Lord Justice Lindley enunciated the following fundamental propositions:

(a) The auditors are the appointees of the shareholders; it is to the shareholders that they must report; their report to the shareholders must be made directly to them, and not *via* the directors; for, only so can the real purpose of the appointment of the auditors be secured, *viz.*, to ensure that the shareholders shall be provided with information as to the true financial position of the company, which shall be reliable and independent.

(b) It is not part of an auditor's duty to give advice; this delimitation of his function applies both in his relationship to the directors and to the shareholders.

(c) It is no part of the responsibility of the auditor to concern himself with problems of direction; it is not his

concern that the company may be conducted upon an imprudent basis or in an unprofitable manner.

(d) So long as he discharges his duty to the shareholders, he need not concern himself with the issue as to whether dividends are properly or improperly declared.

(e) How, then is the *positive* duty of the auditor to be defined? It is, first to ascertain, and then to state, the true financial position of the company at the time of the audit.

(f) With regard to ascertaining the position, he must do his work by conducting an examination of the books; but since the books may themselves not show the true position of the company, he must make such enquiry as may be called for in the particular circumstances, in order to satisfy himself; in short, he must be reasonably careful in the conduct of his examination of the books, i.e., he must not be negligent.

Having properly discharged his duty as to *ascertaining*, he must next apply himself to his duty as to *statement*; in other words, he must draw such a balance-sheet as will genuinely mirror the books which he has examined.

An auditor may discharge his duty of ascertaining with the exercise of reasonable care (and professional skill) and still fail to ascertain the truth, but he will not necessarily by reason thereof, become liable in negligence; for he is not an insurer. He might well be deceived into forming erroneous conclusions without being culpable, since the books may have been fraudulently prepared; whether he ought to have discovered the mode in which, and the means whereby, the fraud was effected, is one of the issues which the Court has to decide upon the particular facts of each particular case.

The auditor must, accordingly, be *circumspect*; he is not required to be *suspicious* of everybody and of every document; but once suspicious circumstances are revealed, he must go on to make a more careful examination than would otherwise be adequate.

The obligation to be circumspect does not involve the proposition that he must do for himself the work which properly belongs to other experts; he is entitled to rely upon the views of specialized experts—in the absence of special reasons, which would direct the mind of a reasonably careful auditor to the existence of circumstances war-

ranting a suspicious attitude towards such experts' opinions.

(g) It follows from the proposition that the auditor is not required to be invariably suspicious, that he is entitled to act as ordinary reasonable business men are accustomed to act, i.e., he is not required to examine every item in detail; it is sufficient if he checks by taking a sufficient number of sample items; as Lord Lindley put it:—

"It is satisfactory to find that the legal standard of duty is not too high for business purposes, and is recognized as correct by business men."

(h) Lord Justice Rigby, in endorsing the views of Lord Justice Lindley, gave, *inter alia*, the following valuable definition (at p. 692):—

"The words 'as shown by the books of the company' seem to me to be introduced to relieve the auditors from any responsibility as to affairs of the company kept out of the books and concealed from them, but not to confine it to a mere statement of the correspondence of the balance-sheet with the entries in the books. For 'a full and fair balance-sheet must be such a balance-sheet as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view.'"

In other words, we here come upon the familiar classification of errors into which the negligent accountant may lapse, viz., errors of commission and errors of omission.

(To be continued)

GENERAL NOTES

Among Our Contributors

H. PERCY EDWARDS, whose history of the Institute of Chartered Accountants of Ontario is published in this issue, has been a member of that Institute since June 1913 and was elected a Fellow on 21st January 1924. He served as a member of Council of the Institute for fifteen years until he retired from office in June 1937 and was President for the year 1929-30. Mr. Edwards also served as President of The Dominion Association of Chartered Accountants in 1927-28, and as Chairman of the editorial committee of THE CANADIAN CHARTERED ACCOUNTANT in 1931-33.

Table of Exchange Rates

(Kindly supplied by The Canadian Bank of Commerce, Toronto)

	31st December 1939	15 January 1940
U.S. Dollars	10 - 11% P.	10 - 11% P.
Sterling	443 - 447	443 - 447
Australian Pounds	359	360
New Zealand Pounds	360	360
South African Pounds	446	446
Belgium—Belgas	1863	1865
Denmark—Kroner	2146	2146
Holland—Florins	5914	5914
Finland—Finmarks	211	205
France—Francs	249	250
Italy—Lire	561	561
Sweden—Kronor	2644	2645
Switzerland—Francs	2491	2490
Norway—Kroner	2523	2524

Note: The above quotations are expressed as follows: Pound currencies—Canadian cents per unit; Continental currencies—Canadian cents per 100 units.

Chartered Accountants and the War

From time to time information is reaching the Editorial Committee from the Secretaries of Provincial Institutes concerning members who are becoming engaged in activities

arising out of the participation of Canada in the War. Following is a memorandum of brief particulars received during January.

Paymaster Commander N. Graham Brown, R.D., R.N.R., Vancouver, has been serving in the Royal Canadian Navy at Esquimalt base since the beginning of December.

Douglas Dewar, Vancouver, was appointed supervisor for British Columbia of the Foreign Exchange Control Board in October 1939.

Capt. R. E. McEwen, Halifax, is at present serving with the Royal Canadian Army Pay Corps as Pay List Auditor of M.D. No. 6.

F. S. Snair, Halifax, is engaged with the District Treasury Office, M.D. No. 6.

Capital and Income

In the Matter of the Estate of George Patterson Murphy

The executors of this estate sought the advice of the Supreme Court of Ontario upon two questions arising in the administration of the estate. The application was heard by Mr. Justice Hogg at Ottawa and reasons for judgment were delivered on 7th November 1939.

One of the questions concerned a dividend paid by a company which at the time of Colonel Murphy's death was his personal holding company. Colonel Murphy died on 22nd February 1938, and from 1st January 1938 till the date of his death the company had received \$9,320.48 as profit or income. On 22nd June 1939 the directors of the company declared a dividend which exhausted the whole of the income for the year 1938, and the question asked by the executors was whether the undistributed income from 1st January 1938 to the date of the death of the deceased was capital of or income from the deceased's estate.

It was held that the amount was income in the hands of the executors. Reference was made to a decision of the Judicial Committee of the Privy Council in *Hill v. Permanent Trustee Company of New South Wales Limited*, 1930, A.C. 720. In that case it was held that a limited company which was not in liquidation could make no payment by way of return

of capital to its shareholders except as a step in an authorized reduction of capital. Any other distribution of money could only be made by way of dividing profits, and moneys declared to be a dividend by the company and paid to a shareholder who was a trustee would belong *prima facie* to the person beneficially entitled to the income of the trust estate. Mr. Justice Hogg accordingly advised the trustees that they received all the moneys comprising the dividend as profits or income of the company with the result that these moneys were income of the estate and belonged to those beneficiaries entitled to the income under the will.

The executors had effected a substantial saving on account of succession duties by prepaying the same before the due dates. Their second question was whether the saving was income of the estate that should be allowed to the life tenants. The learned Judge pointed out that by paying the succession duties in advance the income payable to the life tenants under the will was reduced accordingly. If the executors had not paid the succession duties until the end of the period allowed under the statute the income at 3% which would have been received by the life tenants from the investments or securities realized in order to pay succession duties would have been greater than it was by the amount saved by the prepayment. Consequently the annuitants were entitled to receive the said sum as income.

Canadian Gold Production

Canada now ranks third among the gold producing countries of the world, states *Canadian Finance* (20th December 1939). According to the latest complete annual figures available, the Canadian mining industry enjoyed the greatest year in its history in respect of both quantity and value of output in 1938 when it produced from all primary sources 4,725,117 fine ounces of gold valued at \$166,205,990. This was an increase of sixteen per cent in value over 1937 production. Crude gold bullion produced at mines accounted for 80.8 per cent of the total output.

Practically all newly-mined gold is sold to the Royal Mint at Ottawa or the assay office at Vancouver. It is refined and converted into fine gold bars weighing about

400 ounces each and is sold in the world markets wherever the best net price can be obtained.

Since the discovery of America total world gold production has been estimated at 1,294,935,511 fine ounces. United States output since 1792 is placed at 249,850,780 fine ounces, Transvaal's since 1884 at 340,091,604 and Canada's since 1858 at 65,131,533. Canada's total production has been valued at \$1,605,506,113.

Merchant Shipping Tonnage

The *Monthly Review* (December 1939) of The Bank of Nova Scotia is devoted to a survey of "merchant shipping from war to war." Some of the statistics of shipping tonnages which the *Review* has taken from Lloyd's Register are of interest.

Total world tonnage as of 30th June 1939 amounted to 68½ million gross tons compared with 45½ millions in 1914—an increase of roughly one-third. Great Britain owned about 26 per cent of this tonnage, with total allied strength approximately 35 per cent. If ships under 4,000 gross tons and all vessels over 25 years old are excluded from the total tonnage, thereby leaving what the *Review* terms "efficient ocean-going shipping," Britain's share amounted to 32.6 per cent with the total allied interest at 39.3 per cent. Germany's ownership of this "efficient" tonnage amounted to 6.7 per cent of the total.

While total British tonnage in 1939 amounted to only 26 per cent of the world tonnage (30.6 per cent including Dominion and colonial fleets) as compared with 42 per cent in 1914, most of the reduction has occurred in the smaller size classes, chiefly in ships of from 1,000 to 4,000 gross tons. Of vessels over this size Britain has about 400 more than in 1914, an increase of about four million gross tons. These changes have been the result of the vigorous scrapping and modernization programme carried out during the 1930's. It is noted that the newer vessels have a considerably larger carrying capacity relative to size than was the case twenty-five years ago. Of total allied shipping over 4,000 gross tons 22 per cent is less than five years old and 57 per cent is younger than fifteen compared with world figures of 18 per cent and 46 per cent in the respective age classes.

LÉGAL DECISIONS

[EDITOR'S NOTE: The following are brief summaries of recent decisions of the Canadian Courts as taken, by the kind permission of the Canada Law Book Company, from the *Dominion Law Reports*. In each case reference is made to the volume of the *Reports* where the full judgment may be found. It should be kept in mind that the decisions given may not in every case be final.]

Sales tax—Materials incorporated in bridge—whether “sold” or “produced for manufacturer’s use”

(Dominion Bridge Co. Ltd. v. The King)

Exchequer Court of Canada

Materials manufactured and supplied by a construction company and incorporated by it in the superstructure of a bridge erected under a contract with a provincial Government must be considered as goods sold and delivered to the provincial Government within the meaning of s. 86(1) (a) of the *Special War Revenue Act*, R.S.C. 1927, c. 179, and not as goods manufactured for use by the manufacturer within the meaning of s. 87(1) (d). Hence s. 105 applies and the company is entitled to a refund of sales tax paid in respect of such materials.—[1940] 1 D.L.R. 51.

Taxes (Alberta)—Railway structures—whether “improvements”—Personal property tax and business tax in same district—Situs of vessel

(Re Hudson’s Bay Co., Re Northern Transportation Co. Ltd.)

Alberta Assessment Commission

Held: (1) certain structures and fixtures on a certain railway’s right of way were properly assessed as improvements under the *Assessment Act*, 1938 (Alta.), c. 81, and could not be classified as personal property used in the company’s warehouse business. (2) A personal property assessment may be made, except as restricted by s. 19(1) of the Act, although a business tax is also imposed in the same district under s. 18. (3) A vessel located in one jurisdiction over an extended period will be assessable there notwithstanding that its port of registry is elsewhere.—[1939] 4 D.L.R. 745.

PROVINCIAL NEWS

Taxes—Share certificates of Dominion company—Head office and assets in Ontario—Branch registries elsewhere—Local situs

(Rice v. The King)

Quebec Superior Court

Decedent, domiciled in New York, owned certain shares in a Dominion company, the certificates for which were held for safekeeping in Montreal. The company had its Head Office and principal assets in Ontario but had branch registry offices in Montreal, New York and London, and the certificates in question were issued and registered in Montreal. Held, the situs of the shares was in the Province of Quebec and they were subject to succession duty there.—[1939] 4 D.L.R. 701.

PROVINCIAL NEWS

ALBERTA

Charles M. Lang, of Edmonton, acting provincial auditor of the Province of Alberta, was elected a Fellow of the Institute of Chartered Accountants of Alberta at a meeting of council held 9th December 1939. Mr. Lang was admitted to the Institute of Accountants and Actuaries in Glasgow in 1902. He came to Canada in 1910 to join the firm of Webb, Read and Hegan at Winnipeg. Later in 1910 he arrived in Edmonton to open an office for this firm. In the same year he became one of the charter members of the Institute of Chartered Accountants of Alberta. In 1912 he was forced to give up his work because of the state of his health and, until he enlisted in 1916, practised the occupation of farming. Mr. Lang returned from overseas and was engaged by the provincial government in 1920 as accountant in the department of agriculture. In 1924 he was appointed assistant provincial auditor, a position which he held until 1st April 1936, when he became acting provincial auditor.

BRITISH COLUMBIA

The January dinner and discussion meeting of the British Columbia Institute was held at the Quadra Club in Vancouver on Tuesday 9th January. The meeting was presided over by Mr. W. G. Rowe, President of the Institute,

and the speaker was Mr. Douglas Dewar, F.C.A., Supervisor for British Columbia of the Foreign Exchange Control Board.

Mr. Dewar stated that the foreign investments in Canada exceeded seven billion dollars and that, if only a small part of this huge sum were withdrawn, it would have a serious effect on Canada's foreign exchange position and business conditions generally. The purpose of the foreign exchange control legislation, he stated, was to prevent the outflow of capital, and some of the problems of its administration were outlined. The necessary forms for importation and exportation of materials and funds were dealt with and their purposes explained. The personnel of the Board throughout Canada was also outlined.

The meeting was well attended and at the conclusion of the address the members present were given opportunity to inquire about any other functions of the Board.

Mr. Dewar was given a hearty vote of thanks for his timely and instructive address.

SASKATCHEWAN

The following candidates were successful in the examinations conducted by the Institute of Chartered Accountants of Saskatchewan in November 1939.

Final—A. R. Bevan, Gerald A. Bright, John G. Campbell, Morton Golumbia, Samuel P. Golumbia, W. G. Harding, Clarence E. Lee, W. L. Parrott, and George R. Patterson, all of Regina; Sydney C. Dale, T. H. Dinsley, William F. McWhinney, Sylvan Pirot, of Saskatoon; James J. Duff, Rosetown; Wilfred Quine, Yorkton; J. M. Moynes, Moose Jaw, and J. Arthur Kidd, Ottawa.

Intermediate — Fred. L. Dickson, Weyburn and N. E. Hames, George L. Innes, John H. Morrison, Regina.

Malcolm I. Chase and George Scrimgeour, Regina, passed Part I of the final examination. James C. Garner, Weyburn, was granted a supplemental in municipal accounting of Part I of the final examination, and C. V. Gladwell a supplemental in general accounting.

George L. Innes won the first prize of the Institute, and N. E. Hames the second prize, for their standing in the Intermediate examination.

PERSONALS

Messrs. R. C. Bertram, R. H. B. Hector and R. D. Hill announce that they have entered into partnership for the practice of their profession under the firm name of R. D. Hill, Bertram and Hector, Chartered Accountants, with offices at 443-4 Confederation Life Building, Toronto.

Mr. Max Zaitlen announces that Mr. Abe Zaitlen has been admitted to partnership and that they will carry on the practice of their profession under the firm name of Zaitlen and Zaitlen, Chartered Accountants, 309-311 Avenue Building, Saskatoon.

OBITUARIES

The Late R. H. Hall

The Institute of Chartered Accountants of Saskatchewan regrets to announce the death at Prince Albert on 7th December last of R. H. Hall, a member of the Institute since 1922. Up to the time of his death Mr. Hall had been engaged in the practice of his profession at Prince Albert.

The sincere sympathy of the members of the Institute is extended to Mrs. Hall.

The Late Clifford S. Kilgour

The Institute of Chartered Accountants of Alberta regrets to announce the death at Edmonton, Alberta, on 12th January 1940 of Clifford S. Kilgour at the age of forty-six years.

The late Mr. Kilgour had been a member of the Alberta Institute since 1924 and had been income tax inspector for the Dominion government at Edmonton since 1919. He is survived by Mrs. Kilgour and three children to whom the Institute extends its sincere sympathy.

STOCK BROKERS' ACCOUNTS

This series of discussions on the subject of stock brokerage accounting theory and practice has been prepared by a group of members of the profession familiar with the subject. They desire to have it understood that the definitions, opinions and observations appearing in this column are their own and are not necessarily those of the Dominion Association.

(Continued from January issue)

"When Issued" Contracts

It sometimes happens that securities are traded prior to their issuance. Such transactions are made on an "if, as and when issued" basis and are handled between brokers as "When issued contracts." Customers are sent the usual purchase or sale advice and are entitled to look to the broker for delivery only at such time as the securities do, in fact, become issued and available for delivery. Cases have been known where securities have been traded on this basis, after which, for some reason, the corporation changed its mind and no issue was made. Naturally this would void the contracts previously made.

Customers may go "long" or "short" securities traded on this basis. In Canada it is usual to debit or credit the customer's account with the full cost or proceeds of purchases or sales. Care should be taken to see that interest is not calculated on the amount until such time as the securities become issued and are trading "regular." In the United States the usual practice is immediately to charge the customer with the commission only on "when issued" transactions. When the securities are issued and cleared, the customers are then debited or credited with the balance of the cost or proceeds.

Canadian brokers usually require customers doing margin trading to keep "when issued" transactions to the market. The New York Stock Exchange requires that such trades be margined in the regular manner.

The accounting records for "when issued" contracts do not differ materially from those of regular purchases and sales until such time as the securities become issued. It is then necessary to recapitulate the total trades executed to determine how much stock must be received and/or delivered to brokers.

TERMINOLOGY DEPARTMENT

When the customers are not charged or credited in the first instance with the full amount of the "when issued" contract, the financial statement of a broker should state, by way of a footnote, the total dollar amount of "when issued" contracts bought and sold (shown separately) which were outstanding at the date of the statement. This reflects the fact that the broker has contracted to make delivery of the stock to or for his customers, which delivery depends on future circumstances, i.e. eventual issuance of securities, ability of contracting broker to make commitments, etc.

TERMINOLOGY DEPARTMENT

The articles in this Department, unless otherwise stated, are originally written by the Chairman of the Terminology Committee and submitted to the members thereof; they are afterwards revised by him after consideration of suggestions made by the members.

If it should be thought that any articles include too much primary or elementary matter, readers are asked to realize that the Committee hopes these articles will be of especial value to Students-in-Accounts; and it is believed that, to impart a thorough understanding, too much emphasis cannot be placed on the fundamental principles on which the ideas connoted in the term defined are based.

(Continued from January issue)

T

Tangible: That which has physical existence; literally, that which can be "touched."

Tangible Assets: Those which have a physical value, as differentiated from those which exist in rights, privileges, etc. (see "Intangible"). The tangible value of a business is that of its net tangible assets, including net current assets.

Tare: The weight of a container or vehicle, applied to the gross weight including that of such container or vehicle to determine the net weight of its contents or load; e.g., the weight of a truck, barrel, carton, etc.

Taxes: Charges imposed by a constituted governmental authority on persons, natural or corporate, for the common benefit of all within its jurisdiction.

Tentative Balance Sheet: One prepared for consideration and discussion, not final, but subject to amendment.

Trade Acceptance: One given in consideration of goods purchased in the regular operations of business. The word "Trade" is also attached to such terms as Liabilities, Accounts Receivable, Notes Receivable, to indicate that the particular assets or liabilities have arisen from ordinary business transactions.

Transfer Agent: The official of a Company appointed to attend to transfers of its stock. The appointee of the larger Companies or Corporations is usually a Trust Company, and the office often combined with that of Registrar.

Treasury Stock: Stock or Shares in a Company which, having been issued for consideration, have been donated back to the Company, usually for the purpose of selling again to acquire working capital. The term is sometimes erroneously used to mean Unissued Capital Stock.

Trial Balance: A statement of the balances in a ledger set out in their respective debit and credit columns and which, the columns being agreed, serves to indicate the mathematical accuracy of the accounts and also as a basis for the preparation of financial statements.

Trust Deed—or Deed of Trust: Any document under seal establishing the terms of a trusteeship. The term is usually met with in business in connection with the mortgage or hypothecation of property or securities to a trustee to be held by him as security for bondholders.

Trust and Trustee: A trust is the conveyance or assignment of property or funds to a person called the trustee in confidence that he will deal with it according to the terms of the trust. The property so conveyed is called a "trust fund" or is said to be "in trust." The beneficiary of a trust is known as the "cestui que trust."

Turnover: A term often erroneously used for the amount in value of sales in a business. The accepted usage is to indicate the number of times certain assets (such as stock in trade), personnel, etc., are replaced during a stated period.

STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

NOTES AND COMMENT

We would like to call the special attention of our readers to the content of the Problems and Solutions section in this issue as we believe that the material presented is not only of intrinsic value but that it will also be of considerable interest as evidence of the type of program adopted by one of the most active students' associations and of the manner in which that program is being put into effect.

* * *

It would be interesting to know to what extent single-entry methods of bookkeeping and accounting are still employed in this country, not in the corner store type of enterprise where either single-entry or cash accounting is entirely appropriate but in the larger stores and medium-sized industrial concerns where a complete double-entry system would seem to be essential. The professional accountant is probably not the man who could throw most light on the matter since the type of concern in which single entry is likely to be still existent is the one which has not yet come within his sphere of influence. The burden of the income tax since 1917 must undoubtedly have forced many small concerns to adopt improved accounting methods and since this tax is likely to become increasingly heavy in the immediate future it is to be anticipated that most of the single entry systems which have survived so far will be eliminated by this further pressure.

* * *

An article by Maurice Moonitz and E. Carey Brown on "The Annuity Method of Estimating Depreciation" which appears in the issue of *The Accounting Review** for December 1939 is likely to be more extensively read by accountants and business men today than it would have been a decade or so ago. It was formerly taken for granted that the conventional method of computing periodic income was the correct one or at any rate the most useful one; today the

*Published quarterly by the American Accounting Association, Chicago.

validity of the assumption is being questioned not only by theorists but by men of affairs also. The authors of the article cited arrive by a process of mathematical and economic analysis at the conclusion that the most accurate measure of the periodic depreciation of a fixed asset ("output asset" as they call it) is yielded by a modified form of what accounting texts describe as the annuity method. The modification takes the form of the substitution, in the depreciation calculations, of the market rate of interest by the anticipated rate of return which was in the mind of the *entrepreneur* when he decided to buy the asset. (The *entrepreneur* would, presumably, invest in the asset only if he anticipated that the net revenue yielded by the flow of services would exceed the market rate of interest.) A footnote to the article (at p. 427) startles by demonstrating mathematically that the straight line method of depreciation is only applicable in cases in which the net yield of a fixed asset is zero—that is to say only in cases in which the *entrepreneur* would not have invested.

* * *

STUDENT ASSOCIATION NOTES

NOVA SCOTIA

R. Gordon Harris of Halifax was called up for active service on 7th September last, and now holds the rank of Paymaster Lieutenant, R.C.N.V.R.

QUEBEC

Lieut. Paul Hart is now in England as Signal Officer of the Royal 22nd Regiment.

L/Cpl. D. L. Hart is stationed at Barriefield, Ontario, training centre of the Royal Canadian Corps of Signals.

SASKATCHEWAN—Saskatoon.

The Saskatoon Chartered Accountants' Students' Association held its regular annual dinner at the King George Hotel on Monday, 18th December last. Over forty were in attendance, including many Chartered Accountants of Saskatoon.

Special guests of the evening were Mr. John Parton, F.C.A., of Winnipeg, and the members of Council of the Saskatchewan Institute.

The purpose of the meeting was to honour those students who had passed the recent examinations of the Saskat-

STUDENTS' DEPARTMENT

chewan Institute. Mr. Maurice Hesford, C.A., congratulated the successful students.

Bishop Hallam, Anglican Bishop of Saskatoon Diocese, was the guest speaker of the evening, who in his introductory remarks related a few of his humorous experiences with chartered accountants. His address was very much appreciated.

Mr. H. R. Clark, C.A., was chairman for the evening, Mr. C. P. DeRoche, C.A., introduced the guests, and Mr. V. J. Ferguson, F.C.A., expressed the thanks of the meeting to Bishop Hallam for his interesting and inspiring address.

* * *

PROBLEMS AND SOLUTIONS

For the material presented this month the Department is indebted to The Chartered Accountants Students' Society of the Province of Quebec and to Mr. C. N. Knowles, C.A. The Society's programme of activities for the fall of 1939 consisted of a series of lectures based on questions taken from examination questions of previous years and included the treatment of "Examination Writing Technique" by Mr. Knowles. The material used in this lecture is reproduced below. It will be understood that the opinions expressed are the personal opinions of the lecturer.

1. AUDITING "A," MAY, 1937

Question 5

You discover in the course of a first audit that your client, a holding Company X, controls several subsidiaries designated A, B and C, through owning a majority interest in their stock.

The capitalization and ownership of these companies is as follows:

	Cumulative 7% first preferred shares	Cumulative 6% second preferred shares	No par common shares
COMPANY A			
X Ownership	1,000	...	95%
Minority interest	500	5%
COMPANY B			
X Ownership	900	...	95%
Minority interest	100	500	5%
COMPANY C			
X Ownership	1,000	...	95%
Minority interest	500	5%

The following tabulation shows the surplus and undivided profits account at the beginning of the accounting period and the result of operations for the year:

THE CANADIAN CHARTERED ACCOUNTANT

	Surplus or deficit beginning	Profit or loss
Company A	\$25,000 surplus	\$ 9,000 profit
Company B	5,000 surplus	12,000 profit
Company C	10,000 deficit	18,000 loss

The paid-in value of Company C's common stock is \$25,000.

The schedule below gives the status of the companies in respect to dividends at the beginning of the accounting period and payments throughout the year:

COMPANY A	First Preferred	Second Preferred
In arrears	None	None
Payments	1 year \$7,000	1 year \$3,000

COMPANY B		
In arrears	1 year 7,000	1 year 3,000
Payments	1/2 year 3,500	

COMPANY C		
In arrears	1 year 7,000	1 1/2 years 4,500
Payments	None	None

(a) What portion of the beginning surplus or deficit should be taken into X Company from each subsidiary, and what portion credited to the minority?

(b) Prepare a statement of consolidated surplus at end of current period, and minority balances for each company and also show specifically the treatment of the \$3,000 by which the deficit at end of period exceeds the common stock equity.

SOLUTION AND DISCUSSION

(a) Proportion of surplus or deficit of each subsidiary to be taken into account by X Company as at beginning of period:

COMPANY A	Surplus (Cr.) or deficit (Dr.)	X Co.	Minority
Balance at beginning	Cr. \$25,000		
No arrears of dividends on preferred stocks; therefore X takes 95%		Cr. \$23,750	
Minority takes 5%			Cr. \$1,250
Total		Cr. \$25,000	

COMPANY B			
Balance at beginning	Cr. \$5,000		
First preferred—X 90%	Dr. 7,000	Cr. \$6,300	Cr. \$ 700
Second preferred	Dr. 3,000		Cr. 3,000
Resulting debit balance	Dr. 5,000		
X, 95%		Dr. 4,750	
Minority 5%			Dr. 250
Final result	—	Cr. \$1,550	Cr. \$3,450
Total		Cr. \$5,000	

STUDENTS' DEPARTMENT

COMPANY C

Balance at beginning	Dr. \$10,000		
First preferred—X 100%	Dr. 7,000	Cr. \$7,000	
Second preferred—X Nil	Dr. 4,500		Cr. \$4,500
Resulting debit balance	Dr. 21,500		
X, 95%		Dr. 20,425	
Minority, 5%			Dr. 1,075
Final result	—	Dr. \$13,425	Cr. \$3,425
Total		Dr. \$10,000	

For further comment on the position of Company C see under (b) below.

- (b) Proportion of surplus or deficit of each subsidiary to be taken into account by X Company as at end of period.

COMPANY A

		X Co.	Minority
Balance at beginning	Cr. \$25,000		
Profit for year	Cr. 9,000		
	34,000		
Dividends paid	10,000		
Balance at end	Cr. \$24,000		
No dividends in arrear; therefore X takes 95%		Cr. 22,800	
Minority takes 5%			Cr. 1,200
Total		Cr. \$24,000	

COMPANY B

	Surplus (Cr.) or deficit (Dr.)		
Balance at beginning	Cr. \$5,000		
Profit for year	Cr. 12,000		
	Cr. 17,000		
Dividends paid (50% — 1st preferred)	Dr. 3,500		
Balance at end	Cr. 13,500		
First preferred, arrears —			
X 90%	Dr. 3,500	Cr. \$3,150	Cr. \$ 350
First preferred, current —			
X 90%	Dr. 7,000	Cr. 6,300	Cr. 700
Second preferred arrears —			
X Nil	Dr. 3,000		Cr. 3,000
Second preferred, current —			
X Nil	Dr. 3,000		Cr. 3,000
Resulting debit balance			
X, 95%	Dr. 3,000	2,850	
Minority, 5%			Dr. 150
Final result		Cr. \$6,600	Cr. \$6,900
Total		Cr. \$13,500	

THE CANADIAN CHARTERED ACCOUNTANT

COMPANY C

Since the accumulated deficit, at \$28,000, exceeds the common stock (\$25,000), the simplest solution is to take the stand that there is no surplus to apportion and that, moreover, the deficiency of \$3,000 will be suffered by the second preferred: thus their interest will be consolidated at \$47,000.

In actual practice, however, it may be necessary or at least advisable for the holding company to take a broader view and to respect the interests of its minorities. It may do this wholly or partially. Thus it may set up the first preferred as a minority interest at \$56,000 being \$50,000 capital plus all arrears of dividend \$6,000. This would increase the apparent deficit to \$34,000 and since the minority holders of the common stock could not be expected to contribute, the whole of this deficit would be suffered by the holding company.

Again, if it is the view of the management of the holding company that the present state of affairs is merely a temporary one and that the interests of all the minority holders will ultimately be respected, the following method of setting up the deficit might be the proper one to adopt.

Balance at beginning	Dr. \$10,000		
Loss for year	Dr. 18,000		
Balance at end	Dr. 28,000		
First preferred—arrears	Dr. 7,000	Cr. \$7,000	
First preferred—current	Dr. 7,000	Cr. 7,000	
Second preferred—arrears	Dr. 4,500		Cr. \$4,500
Second preferred—current	Dr. 3,000		Cr. 3,000
Resulting debit balance	Dr. 49,500		
X, 95%		Dr. 47,025	
Minority, 5%			Dr. 2,475
Final result		Dr. 33,025	Cr. 5,025
Total		Dr. \$28,000	

Here, in theory, it is assumed that the common minority will contribute \$2,475 of the deficit as it would be after meeting the claims of both classes of preferred. This would not actually happen in practice, but it is fundamentally true that the common minority would suffer this charge out of future profits before its own interest in any such profits could be established.

Another point which might arise in practice is that if the holding company acquired its interest in C (\$100,000 First preferred and \$23,750 Common) for substantially less than \$123,750, it might be prepared to respect the interests of the minorities "in toto," i.e. as to capital and arrears of dividends in the case of the second preferred and possibly as to capital only (\$1,250) in the case of the common.

Although the original solution propounded above, i.e. to charge the deficiency of \$3,000 against the second preferred is probably the one expected by the examiner, the position of Company C is a very interesting one from the practical point of view.

2. AUDITING "A," MAY, 1938

Question 4

In the course of your audit of a firm of stockbrokers you have sent out statements of the clients' accounts, with a request that the clients

STUDENTS' DEPARTMENT

sign such statements and return them to you. One of these clients writes the following letter to you:

"I enclose herewith the statement of my account with Messrs. Smith, Jones & Co., which I have duly signed, as requested.

"I am coming to the conclusion that you auditors should do your own auditing, and report, if you think it advisable, to the parties interested. I do not think that you should expect us to verify your auditing."

Write a reply to this letter.

SOLUTION AND DISCUSSION

Letter to stockbrokers' client

Dear Sir,

We hasten to reply to your letter of — sent to us along with your verification of the state of your account with Messrs. Smith, Jones & Co.

We can well understand your feeling of vexation in this matter, but if you will have patience with us for a few moments, we will endeavour to explain why your co-operation is so important to us.

You will, we are sure, appreciate that in many cases, transactions for clients are often made by brokers upon instructions given to them verbally—sometimes over the telephone. It follows therefore that an unscrupulous employee might cause a fictitious entry to be made in your account and claim that it was justified by some verbal message to him. Thus it is important that you be kept informed of the state of your account.

You may contend that this happens in any case, in that you do receive a statement regularly, but it should be borne in mind that such statements would normally be available to the staff of the broker, and if there were irregularities the person responsible for them would see to it that the statement you received contained only those entries which you had duly authorized. That is why the verification we sent to you was prepared from your ledger account and mailed by us, with a specific request that it be returned direct to our office. In any case, and quite apart from the question of fraud or manipulation, your assistance is of great help in eliminating ordinary bookkeeping errors.

We trust you will understand that the precautions we take are for the mutual benefit of our client and yourself. Your co-operation is invaluable to us and is appreciated accordingly.

We should be glad to give you any further information you may desire upon this matter.

Yours very truly,

NOTE:—Although the examiner presented this question in somewhat unorthodox fashion, there is little doubt that he expected an answer which would indicate the extent of the candidate's knowledge as to why it is important to obtain confirmations direct from clients and customers. Thus, it is primarily a technical question, but the form of the answer required, i.e. a letter to the brokers' client, also makes it an interesting practical problem, requiring an answer in which the candidate must express himself lucidly and display a sense of tact and judgment.

3. AUDITING "A," OCTOBER, 1938

Question 5

You are engaged to investigate the affairs of a manufacturing company in a small town on behalf of prospective purchasers.

- (a) Describe briefly what investigation you would make as an accountant.
- (b) Mention five matters which you might recommend for investigation on general business principles.

SOLUTION

- (a) Matters to be investigated by you as accountant:
 1. The trend of sales for as many years as possible.
 2. The trend of profits for as many years as possible.
 3. Extraneous or non-recurring items in the profit and loss account.
 4. Special expenses brought about through lack of working capital, e.g., bank interest and discount charges; excessive discounts offered to customers for prompt settlement.
 5. An analysis of sales and cost of sales by products (if possible) or possibly by territories.
 6. Comparative balance sheets as at the beginning and the end of the period under investigation, showing increases and decreases, and a statement of source and application of funds.
 7. Provision for depreciation.
 8. The sales ledger, to decide as to the extent of continuity and diversification. Where the product is disposed of chiefly to a few large customers, the loss of one or more following a change of ownership may be a serious matter. A review of the sales ledger should also reveal whether the concern enjoys repeat orders, or merely builds up its volume by securing new customers, leaving a trail of dissatisfied ones behind it.
 9. Any special or onerous commitments, e.g., leases, raw materials at high prices, contracts for new equipment or advertising campaigns.
 10. Additions to fixed assets.
 11. Salaries and duties of executives.
 12. Special factors contributing to success or failure, e.g., changes in fashions, substitutes, etc.
- (b) Matters to be investigated on business principles.
 1. Labour supply.
 2. Proximity to market and freight rates.
 3. Power supply.
 4. Standing in community of present owners.
 5. Raw material supply.

4. AUDITING "A," OCTOBER, 1938

Question 7

Comment on the statement that: "It is no part of the auditor's duty to give advice . . ."

SOLUTION

The phrase "It is no part of the auditor's duty to give advice" is part of Lord Justice Lindley's judgment in the case of The London and General Bank. He was endeavouring to outline what he deemed to be the chief duty of an auditor and it must be admitted that within limits, his remarks were very much to the point.

However, in these modern times it is somewhat doubtful as to whether his remarks would be as pertinent. It is true that from the theoretical point of view the position of the auditor has not changed, but in practice today he would not be very popular if he took the attitude that he was not supposed to offer advice. In fact, it is the complaint of many clients that the work of auditors is not sufficiently constructive, although without realizing it they are confusing the functions of an auditor with those of a consulting accountant.

The duty of the auditor, as such, is to examine the records placed before him, to ask for such information and explanations as he may require and to report upon what he has found, without comment to the people in charge of those records and information. In most cases, however, he is asked for his advice and usually gives it freely, but in so doing he has temporarily abdicated his post as auditor and turned consultant. In practice it is difficult to draw a definite line of demarcation where one function ceases and the other begins.

To sum up, if the following question were put to an auditor in Court: "You knew these people were not recording transactions properly, why did you not show them what to do?" it might be embarrassing to have to reply "That, sir, is not my job."

HINTS TO EXAMINATION CANDIDATES*

(a) Read the question thoroughly—every word and punctuation mark.

(b) Decide definitely what the question requires in reply, and if necessary underline that portion of it which indicates what is expected. It is also a good plan to underline important dates, rates of interest, etc.

(c) If the question says "How would you, etc?" then say what you would do. If there is an alternative school of thought, mention it briefly.

(d) If the question states "Discuss, etc." be sure to do so. Do not give a one-sided, dogmatic reply, but try to show that you appreciate that there may be several points of view, and deal with them all fairly. To illustrate, suppose a question requires you to discuss the matter of Secret Reserves. In such a case it is a good plan to make brief notes of the points you intend to cover and, if possible, to match each point in favour of such reserves against each point against them.

(e) Try to appreciate the difference between "answering" and "discussing." A straight answer calls for facts, whatever they may be. For example, a question which states "Discuss the provisions of Sec. 114 of the Companies Act," requires very different treatment from one which states "What are the provisions, etc."

(f) Do not "pad" an answer. If it appears to be short, but you have said all that you think you should say, leave it. The examiner will not be impressed by attempts to bewilder him by introducing extraneous matters, or labouring the points already made.

(g) Use the "tabular" method wherever possible and, of course,

*The Lecturer spent a portion of the time available upon the "technique" of answering examination questions. This is a summary of his remarks in this connection.

THE CANADIAN CHARTERED ACCOUNTANT

where it is suitable. That is, list the points made under numbers or letters.

(h) Do not alter or cross out. Train yourself to make up a whole sentence in your mind before you put pen to paper. You will thus save time and send in a much neater paper.

(i) Avoid what might be termed the "company complex." It is not to be supposed that an auditor is always the auditor to a company. If such is the case, the question will usually say so, or at least indicate it in some way. Where there is any doubt, attack the question from the broad point of view, but indicate that where a company is involved, your remarks might require adjustment.

(j) Where a question has to do with some matter which has been the subject of litigation in the past, do not hesitate to mention the case. If you cannot remember the actual name, then indicate to the examiner that you are aware that there is such a case, but that you have momentarily forgotten the name of it.

